

# The search for growth

## Opportunities and risks for institutional investors

A report from the Economist Intelligence Unit



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# Introduction

**A**lthough a gradual global economic recovery is now underway, these remain uncertain times for both investors and corporations. 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 continually 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 the 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. At its heart is a set of scenarios; we asked respondents to indicate how likely they thought each scenario was, and then asked them to tell us what impact it might have on their portfolio. The results provide a fascinating insight into the current mindset of investors and executives around the world.



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### 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

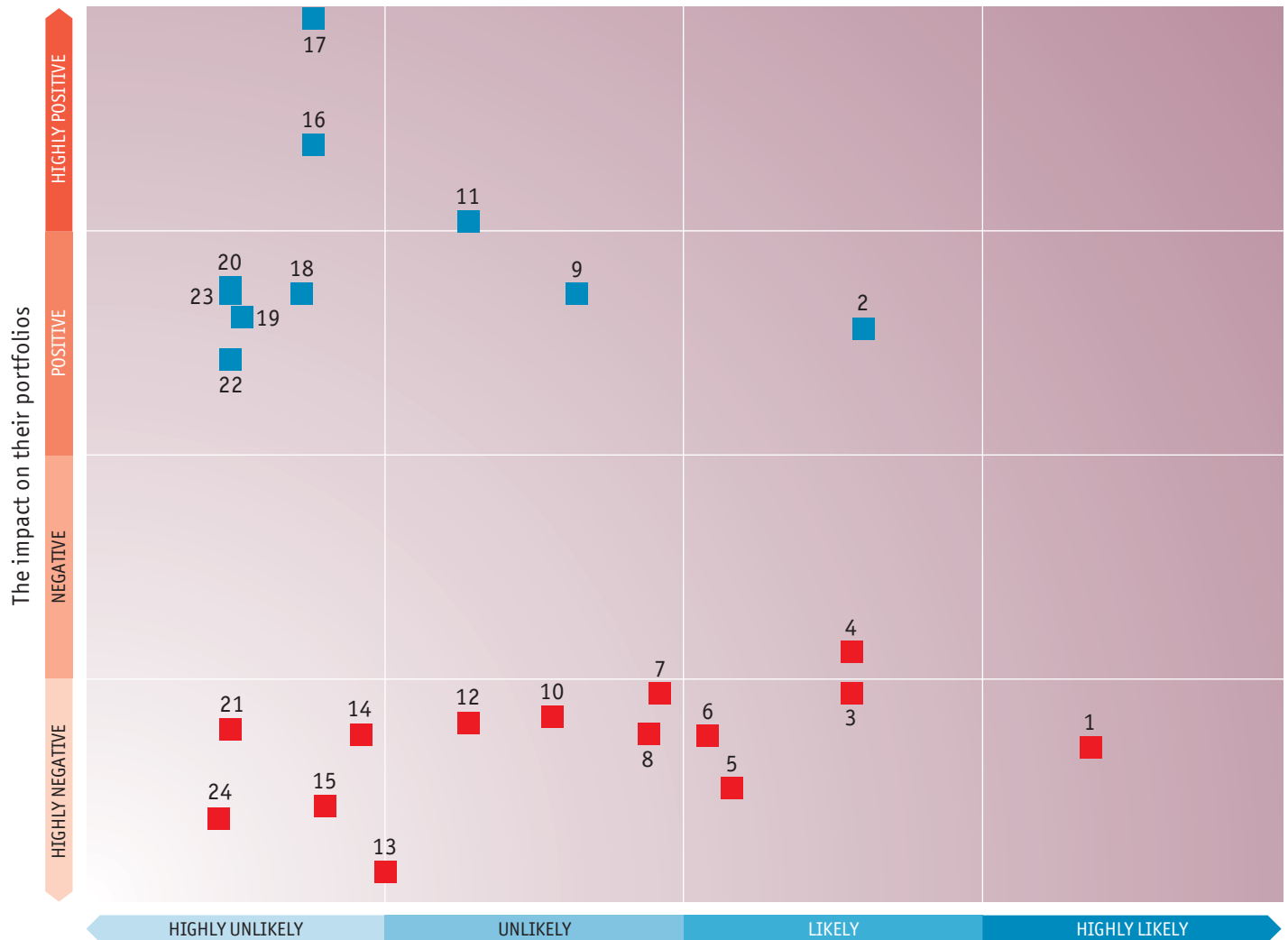
for growth across a wide range of sectors, regions and asset classes. It also explores the likelihood and potential impact of a range of both positive and negative scenarios.

The Economist Intelligence Unit conducted the survey and analysis, and wrote the report. The findings and views expressed in the report do not necessarily reflect the views of the sponsor.



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Chart 1 **Scenario heat map**



Respondents' assessment of the likelihood of a range of scenarios

- 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
- 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
- 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

Source: Economist Intelligence Unit



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# Executive summary

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, a larger proportion 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 in light of 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 prospects, 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 exports 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 corporations may be an underestimated source of growth.



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### **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 prevent 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 will 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 industry, 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 mergers and acquisitions (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 natural catastrophes, including the earthquake and tsunami in Japan.



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### **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 continuing unrest in Syria, Yemen and Bahrain, 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 that have “stagnant political regimes”, where socio-economic problems remain unaddressed and where an outwardly stable regime could prove brittle.

### **Challenges to 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, the resultant effect would be extremely positive, according to respondents.



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# The global outlook

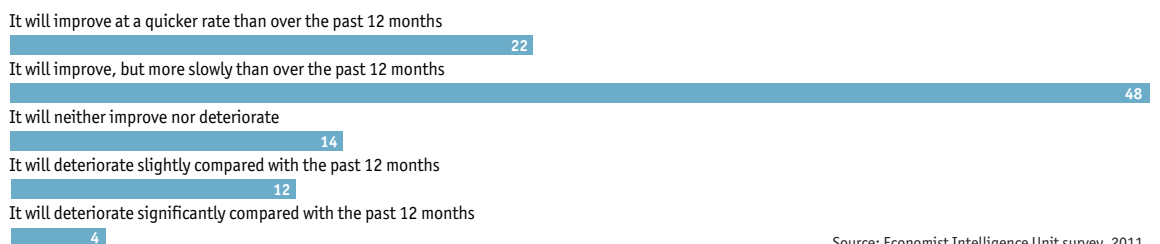
**I**t is now three years since the global financial crisis threw the world into disarray. After a period of unprecedented fiscal stimulus and loose monetary policy, there are signs of stabilisation. According to the Economist Intelligence Unit, global economic growth rallied to 4.9% in 2010, following a strong recessionary bounce-back. As relative normality returns, countries are gradually withdrawing fiscal stimulus packages and raising interest rates from their record lows.

But this return to a more stable footing for the global economy has been undermined by a series of shocks in early 2011. A wave of political unrest across the Middle East and North Africa has led to the collapse of longstanding regimes in Tunisia and Egypt and to armed intervention in Libya. This has exacerbated a rise in oil prices, stoking inflation and denting investor confidence. Japan's tragic earthquake and tsunami have also caused a ripple effect across financial markets and the broader economy, although the impact on economic growth will be tempered by a strong rebound in activity in the second half of 2011 as logistics are restored to normality and reconstruction work gathers steam. And sovereign debt woes have once again emerged in the Eurozone, with Portugal joining Greece and Ireland in requesting a financial rescue package from the European Commission.

Notwithstanding these headwinds, the consensus among survey respondents is that the global economic recovery will continue. But there is disagreement over the pace of that improvement. Just under one-quarter think that the pace of improvement will pick up over the next 12 months, but almost half say that the pace of recovery will slow over that timeframe (see chart 2).

Chart 2 **Which of the following statements best expresses your view on the outlook for the global economy over the next 12 months?**

(% respondents)



Source: Economist Intelligence Unit survey, 2011.



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Richard Urwin, head of economics and asset allocation at US firm BlackRock's fiduciary mandate investment team, believes that the cumulative impact of these downside risks will slow the pace of recovery. "In isolation, factors such as policy tightening in emerging economies, the rise in the price of oil and events in Japan aren't particularly powerful, but bring them together and it becomes likely that we will see a shift to a slower growth environment," he says.

The mixed economic picture translates into a view that there are opportunities for investors, but continuing fear about downside risks. Although 86% of respondents agree that there are significant opportunities in financial markets, 58% think that there are major downside risks that are preventing them from taking advantage of those opportunities (see chart 3).

### Chart 3 Which of the following statements best expresses your view about current growth opportunities in the financial markets?

(% respondents)

There are significant opportunities and I/we intend to take advantage of them

28

There may be significant opportunities, but there are major downside risks that are preventing us from taking advantage of them

58

I don't believe that there are significant opportunities in the current market

14

Source: Economist Intelligence Unit survey, 2011.



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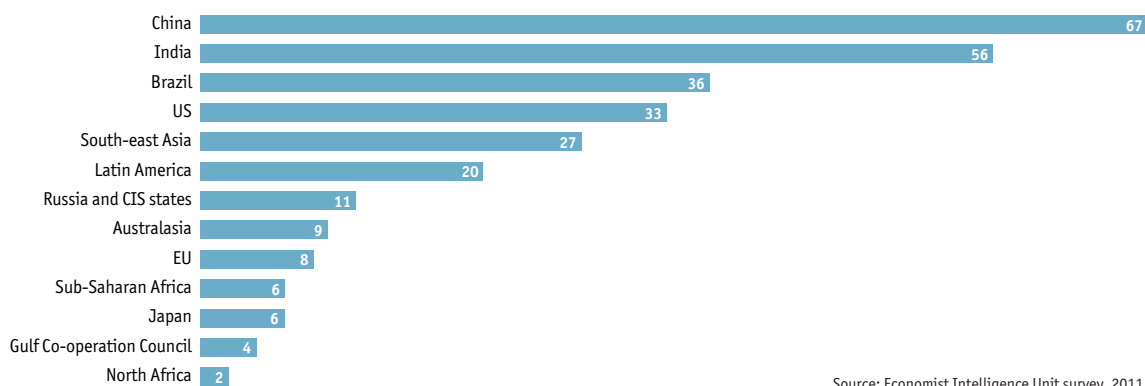
# Overheating in emerging markets

Even before the global economic crisis, the gap between developed and emerging markets was narrowing. Owing to globalisation, more open market policies and increases in productivity and consumption, more than 85% of developing countries grew more quickly than the US between 2002 and 2008. Post-crisis, emerging markets have continued to grow, while the developed economies are largely struggling to embed a sustained recovery. According to the IMF's April 2011 *Global Economic Outlook*, emerging markets will grow by 6.5% in real terms in 2011 and 2012, while advanced economies will grow by just 2.5% in 2011 and 2012.

Our survey respondents are extremely bullish about the prospects for emerging markets. Asked which countries or regions in the world offer the best prospects for economic growth over the next 12 months, they point to China, India and Brazil as being the most promising markets (see chart 4).

Looking to the longer term, the emerging markets story is one that is likely to remain positive. "The big emerging markets have strong population growth and are witnessing increases in productivity as people move from agriculture to manufacturing, or from rural areas to urban areas," says Kelvin Blacklock, chief investment officer, global asset allocation for the UK's Prudential Corporation Asia's Fund Business. "These are long-term positive drivers for these economies. This process is probably

Chart 4 **Which three countries/regions of the world do you think offer the best prospects for economic growth over the next 12 months?**  
(% respondents)



Source: Economist Intelligence Unit survey, 2011.



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much more advanced in China than it is in India, but, even if China starts to slow down, India can accelerate in a structural sense.”

From a growth perspective, emerging markets have a number of key advantages over developed economies. “In many cases, these markets have got better competitive positioning in terms of labour costs, flexibility of operations, and greater policy flexibility,” says Robert Talbut, chief investment officer for the UK’s Royal London Asset Management. “They also have a big advantage in terms of demographics, while a lot of the developed world has got a looming black cloud in that regard.”

While developed economies are struggling to sustain a cyclical recovery, the challenge for the emerging markets is very different. Their priority is to prevent the risk of overheating in a context of higher capital flows, rising inflation and closing output gaps. As margins of excess capacity are used up, the signs of overheating are starting to become more visible.

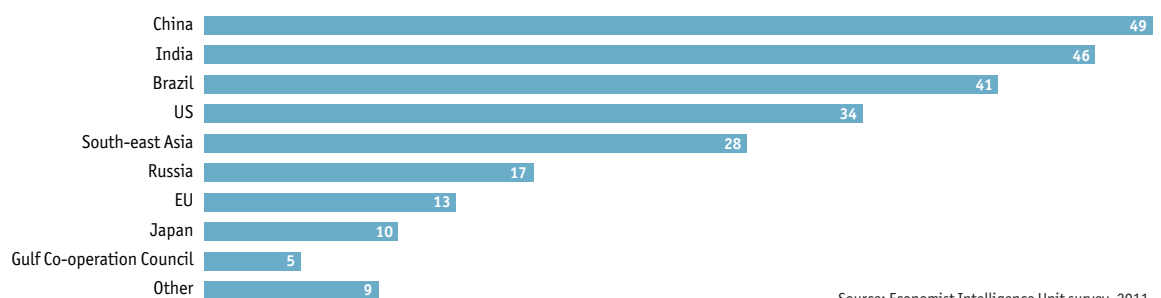
“There’s a limit to how fast you can grow before you cause problems,” says Mr Blacklock. “Sometimes it’s an issue with physical constraints—for example, you physically might not be able to get enough goods in and out of the country because the ports can’t keep up. I think we might also see an acceleration of policy tightening in emerging economies, as they realise that the inflation is stickier than they hoped, and it isn’t going to go away by the middle of the year because food prices aren’t going to collapse.”

## Asset-price growth: a case for being “overweight” in Asia?

Given the strong growth expected in emerging markets, it is no surprise that respondents believe that emerging-market assets will deliver good growth prospects for investors. Asked which countries or regions will offer the best potential for asset-price growth over the next 12 months, respondents point to the same three markets (China, India and Brazil) as being the most promising (see chart 5). Emerging-market equities, in particular, are seen as attractive (see chart 6).

Chart 5 **Which of the following regions and countries of the world do you think offer the best potential for asset price growth over the next 12 months?**

(% respondents)



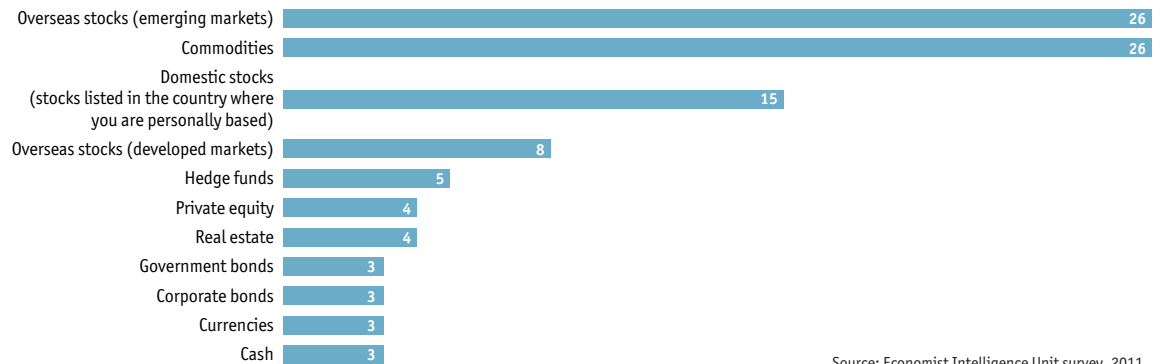
Source: Economist Intelligence Unit survey, 2011.



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Chart 6 **Over the next 12 months, which of the following asset classes do you think will perform most strongly?**  
(% respondents)



Source: Economist Intelligence Unit survey, 2011.

A number of respondents share the enthusiasm for emerging-market equities, particularly in Asia. “We’re pretty constructive about exposure to equities in the Far East,” says Mr Talbut. “These assets have got considerable competitive advantage because of the domestic growth prospects, in addition to the potential from export markets.”

Recent months have seen considerable volatility in Chinese equity markets as a result of concerns about the impact of increases in reserve requirements and interest rates. But, despite this short-term uncertainty, most investors still believe that the long-term trends for equity investment in Asia remain attractive. “We continue to have an overweight position in Asia,” says Basil Demeroutis, a partner at Capricorn Investment Group, a US investment management firm. “Notwithstanding the most recent cooling-off in the equity markets, you have to think long term. There are secular trends that are now firmly entrenched to ensure that Asia, and China in particular, will become an increasingly important part of the global economy.”

Quentin Fitzsimmons, executive director and head of government bonds and foreign exchange at Threadneedle (UK), takes a similar view. “We are and continue to be very interested by the prospects of emerging-market equities,” he explains. “We certainly like emerging-market equities exposure from a strategic perspective, because of the growth rates in those economies, because of the increasing wealth of their consumers.”

## A new bubble in emerging markets?

The risk of overheating and high rates of volatility in emerging-market assets is one that is paramount in the minds of many investors. Two-thirds of respondents believe that emerging-market assets offer very strong potential for growth, but are concerned that some markets could be overheating (see chart 7). And almost half of respondents agree that investors are pinning too much hope on emerging markets as a source of growth over the next 12 months (see chart 8).

Overheating markets carry an increased risk of overpaying for assets. Indeed, research shows that the countries that are growing most rapidly do not always deliver the highest investment returns. Often, investors pay too high a price because the growth has already been priced into asset values. One metric

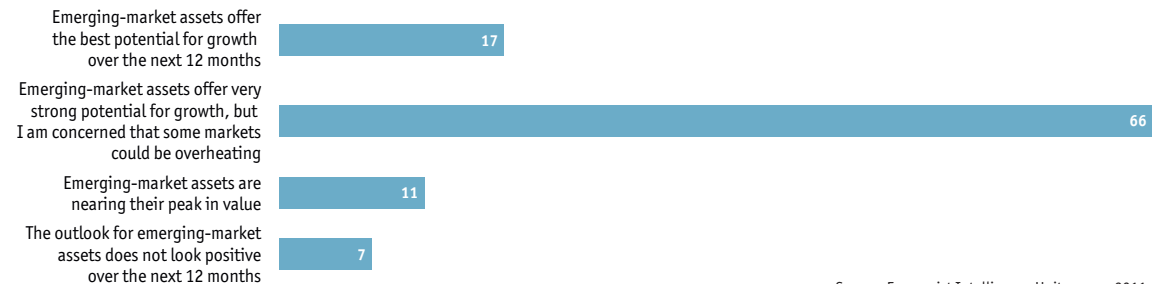


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Chart 7 **Which of the following statements best expresses your view of investing in emerging-market assets (eg, BRIC countries)?**

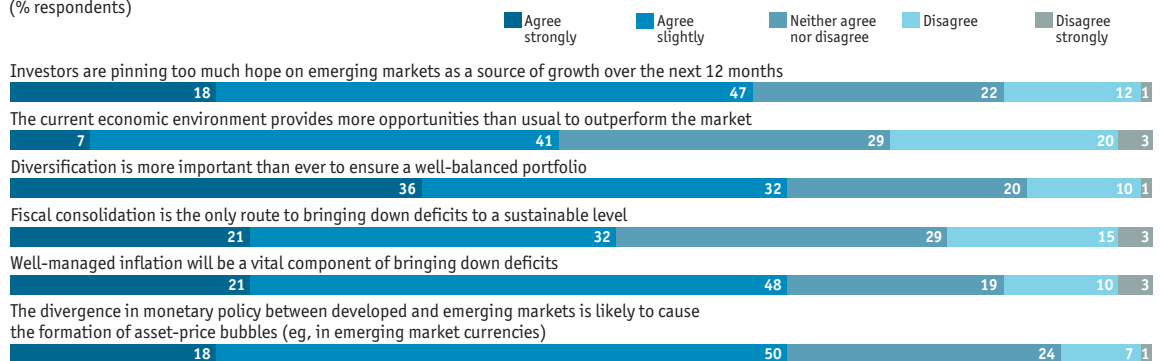
(% respondents)



Source: Economist Intelligence Unit survey, 2011.

Chart 8 **Please indicate whether you agree with the following statements.**

(% respondents)



Source: Economist Intelligence Unit survey, 2011.

to watch is the price to book ratio, which compares a stock's market value to its book value. If this gets too high, it's a sure sign that assets are valued too highly. "When an emerging-market price to book ratio gets above two, you tend to get pretty poor returns in the next two to three years," says Mr Blacklock. "At the moment, the Asian average equity is trading about 2.2 times to book and Indonesia is trading at four times to book, suggesting that a lot of the good news in terms of expected future growth from Asia is already in the price."

Harlan Zimmerman, a senior partner at Sweden-based Cevian Capital, points out that investors can always get access to growth potential in emerging economies through their own domestic markets. "Investing directly in emerging-market equities isn't the only way to take advantage of the growth of these markets," he explains. "Many of the biggest companies in the developed world are also seeing tremendous growth through exports to the emerging markets. Given the better track record of companies in the developed world in terms of governance, this can often be a preferable way of accessing this growth potential. And, given the high valuations of many stock markets in the emerging markets, it is often also cheaper to access the growth potential through such developed-market companies."

Equally, it is important not to generalise. While overheating has become a feature of some emerging-market asset classes (property in China is a good example) these are huge, diverse economies that exhibit



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a wide range of characteristics. “There isn’t only one story,” says Dong ik Lee, managing director and head of the private markets group at Korea Investment Corporation, a sovereign wealth fund. “Sure, there are signs of overheating, but if you know the market well enough you can still find plenty of good investment opportunities, such as in small caps or mid caps.”

## Inflation and social stability

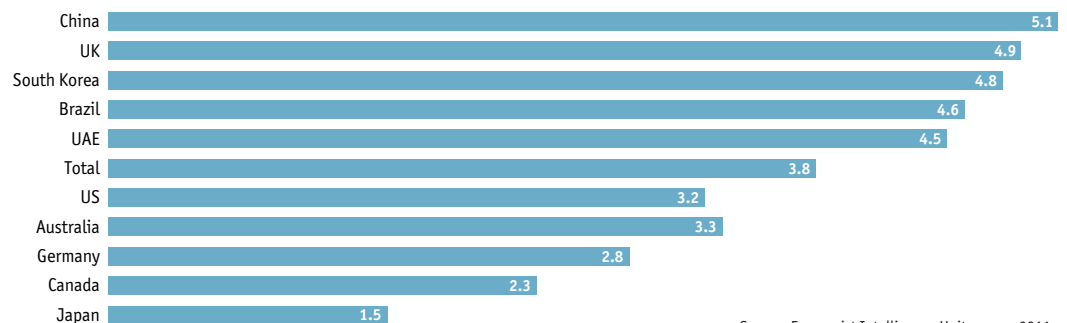
During the global recession, central banks around the world repeatedly reduced interest rates in an attempt to avert a major depression. These loose monetary conditions have resulted in a considerable flow of liquidity around the global economy that has undoubtedly contributed to inflation, particularly in emerging markets.

In China, keeping inflation under control has become the single most important policy challenge. In February, year-on-year consumer price inflation hit 4.9%. Inflation is even more pronounced in India, with January seeing a year-on-year growth rate of 8.3%. Earlier this year, Indian prime minister, Manmohan Singh, said that inflation posed a serious threat to India’s high-growth plans.

These rates of inflation in the world’s most important emerging markets have raised questions over the ability of these economies to grow at their trend rates without triggering an inflationary spiral. In response to growing concerns about inflation, central banks in India, Indonesia, Brazil and China have all tightened monetary policy in recent months.

Among our survey respondents, expectations for inflation vary widely depending on the market. Asked about the figure they expected for consumer price inflation over the next 12 months, the mean response globally was 3.8%. But looking at respondents by country, we find a range from 5.1% in China to 1.5% in Japan (see chart 9).

**Chart 9 On average, what is your expectation for the level of consumer price inflation in the market in which you are personally based over the next 12 months?**  
(% respondents)



Source: Economist Intelligence Unit survey, 2011.

Despite growing concerns about the impact of inflation, interviewees questioned for this research do not consider that it will be a major inhibitor of growth. “Inflation is certainly more of a problem than it was 12 months ago, but it needs to be put into context,” says Mr Talbut. “It may be relatively high compared with the 1990s or earlier this decade, but we’re certainly not talking about inflation coming back [up] to 1970s levels.”



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### Fear of social unrest

A more immediate problem is the potential for soaring food prices to spark social unrest. The high price of food is thought to have been one of the catalysts of the unrest in Tunisia, which led to the ousting of Zine al-Abidine Ben Ali as president in January 2011. Respondents to our survey are certainly concerned by the potential for food prices to cause further disturbances. They consider it to be a highly likely scenario and, if it materialises, to have a very negative impact on their portfolio. A recent paper from the IMF<sup>1</sup> looks at the link between food prices and unrest between 1970 and 2007, and concludes that a 10% increase in international food prices leads to an additional 0.5 in anti-government protests over the following year in low-income countries—a 100% increase compared with the annual average.

Recent research by UK-based Control Risks Group also shows a strong link between food prices and social unrest. “That’s an area to watch, simply because food prices are not altogether driven by year-end stocks,” says Michael Denison, research director. “You also see the intervention of market players, speculation and hoarders that are distorting the price.”

Mehmet Ögütçü, a director at BG Group (UK), is less worried about the social impact of increased food prices in the short term in certain Middle-East and North-African (MENA) countries. “Given the amount of money that the governments have thrown at containing social unrest through heavy subsidies, I see this more as a potential problem in the long term and perhaps imminently in resource-poor MENA and Commonwealth of Independent States (CIS) countries, where the governments do not have the financial muscles to sustain social support,” he says.

1. *Food Prices and Political Instability*, IMF Working Paper, 2011.



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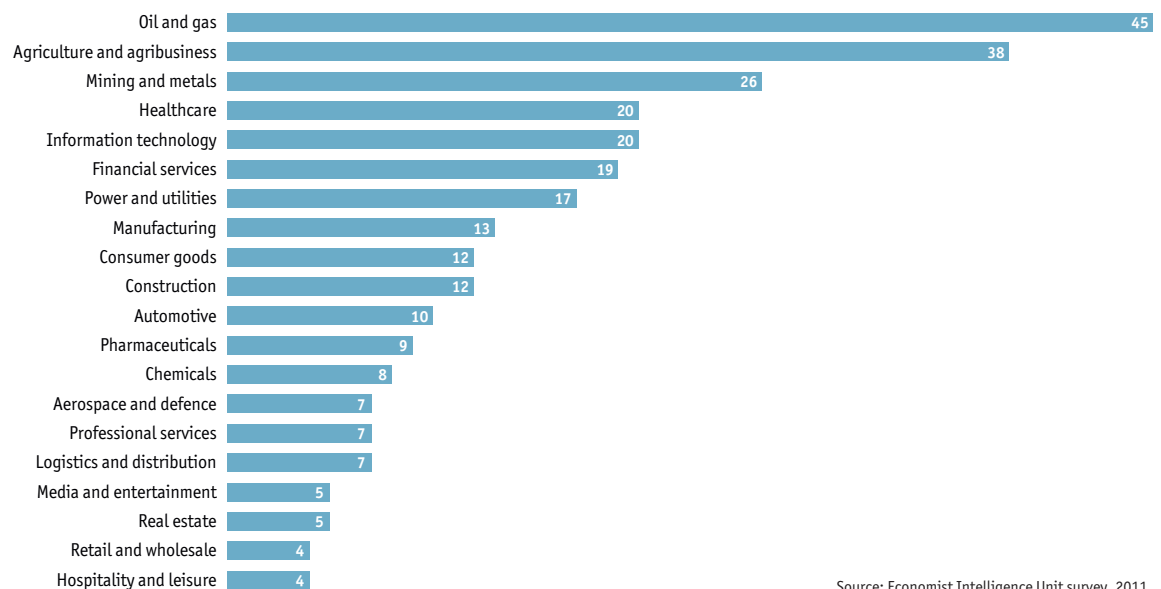
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# Commodities as a safe haven?

A decade ago, commodities were widely regarded as a relatively stable, slightly boring asset class. Prices were low, supply usually met demand and, as a consequence, few investors paid much attention to them. How times have changed. Today, commodities are seen as second only to emerging-market equities as offering the best opportunities for investment growth over the next 12 months (see chart 6). Respondents to our survey also expect industries involving the production of commodities, such as oil and gas; agriculture and agribusiness; and mining and metals, to be those that offer the best opportunities for growth (see chart 10).

Many investors, in search of yield in an environment of ultra-low interest rates and ample liquidity, have piled into commodities as a source of strong potential growth. Barclays Capital (UK) estimates that US\$60bn was injected into commodities in 2010. High-frequency traders, who use computer algorithms to seek out pricing discrepancies, have been particularly active, and helped to send volumes in energy,

Chart 10 **Which of the following industries do you think offer the best opportunities for revenue growth over the next 12 months?**  
(% respondents)



Source: Economist Intelligence Unit survey, 2011.



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metals and agricultural commodities at the CME, the largest US futures exchange, to a record high in 2010, according to *The Financial Times*.

Investors are also attracted to commodities as a protection against inflation and as a natural hedge against event risk, as they behave differently from other financial assets. For example, commodities often perform well during periods of rising inflation and political uncertainty, when other assets like equities and bonds may perform poorly. But although commodity prices have increased, so has volatility. In March, the US main cocoa futures contract plunged by 12.5% in less than a minute, in an event that drew comparisons with the “flash crash” of May 2010, when the US stock market briefly fell by more than 8%.

The Economist Intelligence Unit expects an increase of 28% in 2011 for its world commodity index, a basket of 22 hard and soft commodities. Prices have been driven up sharply in recent months by a combination of supply constraints, restocking in OECD countries, strong investor interest and rising demand from emerging markets. Figures from Barclays Capital, for example, reveal that China, Brazil, India and the Middle East’s share of global coal demand increased from 36% to 55% between 2000 and 2009, while their share of demand for soybeans rose from 33% to 44%.

“The impact of demand from the emerging markets has been huge,” says Mark Swinnerton, head of market analysis at BHP Billiton, an Australia-based mining company. “China, in particular, has a very commodity-intensive path of economic development that has a big influence on commodity prices.”

The rate of urbanisation in China is staggering, and continues to have a significant impact on demand for commodities. According to McKinsey, the urban population of China will expand from 572m in 2005 to 926m in 2025, before reaching 1bn by 2030. By 2025 there will be 221 cities in China that have more than 1m people. The number in Europe today is just 25. As part of its latest five-year plan, the government has said that it will build 36m new housing units, with 10m of those expected this year. “These are mostly high-rise buildings, which are even more resource-intensive,” continues Mr Swinnerton. “There will also be enormous associated demand for white goods, which will again drive demand for commodities.”

Oil prices, already nudging higher owing to the global economic recovery and increased demand from emerging markets, rose significantly in early 2011 as civil unrest in the key producing MENA region led to a heightened risk premium in the market. So far, however, this political turmoil has not restricted supply, and OPEC member states have increased capacity to offset any decline in output caused by cuts in Libyan production.

Supply-side issues have also been important in other commodities. In the agricultural sector, poor harvests in the second half of 2010 caused prices to rise sharply. “In my view, this is the most significant supply-side shock in the world economy since 1973 and it absolutely cannot be fixed in a hurry,” says Pippa Malmgren, president of Canonbury Group and Principalis Asset Management (UK). “We’ve got a very big structural problem on the agricultural supply side. I am very bullish on those assets that are in short supply. And as growth picks up in the West as a function of the cheap money and low interest rates, the demand will increase, but the supply will not.”



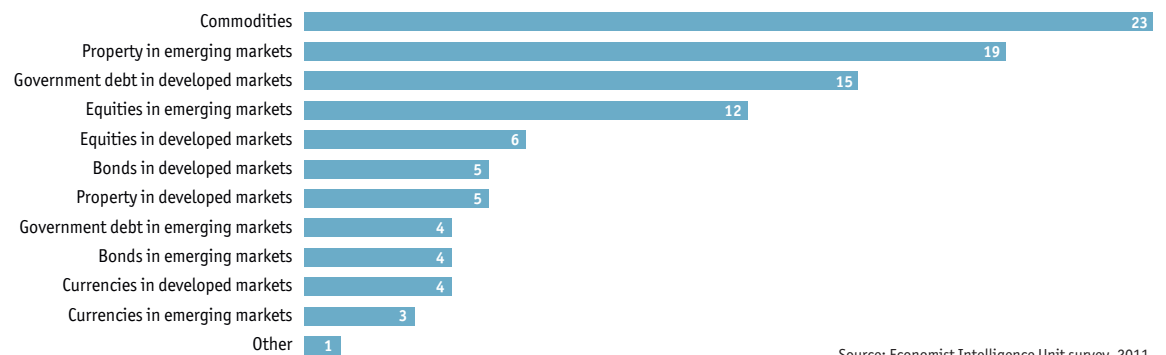
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# Commodities: a strong outlook, but risk of a bubble

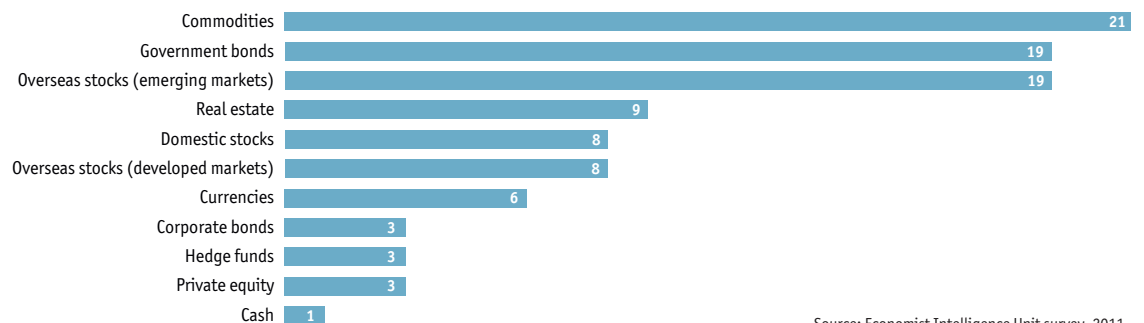
Increasing demand and supply constraints may point to an inexorable rise in prices over the medium term, but there are numerous signs to suggest that commodities, like some emerging-market assets, are overheating. Asked which asset class is most likely to be the source of the next price bubble, respondents point to commodities (see chart 11). They also consider that commodities will be the asset class where levels of risk are most likely to increase over the next 12 months (see chart 12). “From what we’ve observed, commodities are the most bubble-like asset at the moment,” says Mr Blacklock. “It feels to us like there’s a high speculative demand for commodities, and that’s driven some of these assets up to kind of bubble-like levels, which feels quite vulnerable.”

Chart 11 **In your view, where is the next asset price bubble most likely to form?**  
(% respondents)



Source: Economist Intelligence Unit survey, 2011.

Chart 12 **Which of the following asset classes do you think are most likely to increase in level of risk over the next 12 months?**  
(% respondents)



Source: Economist Intelligence Unit survey, 2011.

Numerous observers have highlighted the risks of a bubble in commodity markets. Loose monetary policy and the quantitative easing programme from the Federal Reserve (the Fed, the US central bank) have caused a fall in the value of the dollar and an increase in the prices of dollar-denominated commodities, such as gold. After the restocking period in the immediate wake of the financial crisis, demand for commodities is unlikely to rise significantly. And even in emerging markets, consumption is likely to fall as a result of stockpiling and a shift to less commodity-intensive production. These factors



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could all cause commodity prices to fall—perhaps dramatically so.

But despite fears of a bubble, respondents to our survey still think that the commodity price super-cycle has some way to run. An increase in oil prices to more than US\$150 a barrel is seen as likely, while respondents also think it likely that there will be widespread social unrest caused by soaring food prices (see chart 1). Furthermore, respondents expect that both these scenarios would have a very negative impact on their portfolios.

The impact of a sudden withdrawal by investors from commodities could also have a broader effect on financial markets, believes Mr Blacklock. “They will drag a lot of other risky assets down with them,” he says. “People may lose money in commodities and may scale back on their other investments. But I don’t think it would kill the rest of the world’s risky markets.”



## Prospects for developed markets

**D**eveloped markets face a daunting array of problems, including high levels of unemployment, poor demographics and a damaged financial sector.

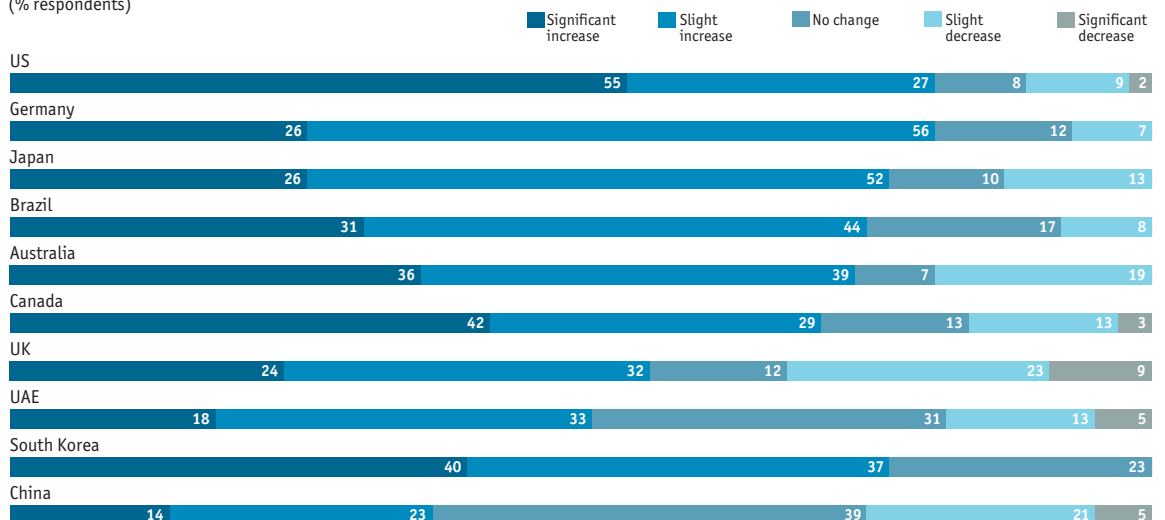
Following the bail-outs during the financial crisis, weakening fiscal balances during the recession, and with medium-term growth prospects at best sluggish, government debt will remain a major issue for many years to come. According to respondents, the US, Germany and Japan are the three countries that will most need to increase their debt levels over the next 12 months. The US will need to increase borrowing in part to pay for ongoing stimulus measures, while Germany will need to do so to fund bail-outs in the Eurozone and Japan to deal with the impact of the devastating recent earthquake (see chart 13).

But despite the challenges that developed markets face, there are bright spots among the gloom. Some investors see a gradual rebalancing of the global economy, with certain developed markets recovering more quickly, while rates of growth slow slightly in the emerging world.

“Our sense is that the global economy is getting into a more self-sustaining recovery,” says Mr Blacklock. “Last year, there was an awful lot of concern around the levels of debt and how this would drag

**Chart 13 Over the next 12 months, what change do you expect to government debt ratios across the following categories in your domestic market?**

(% respondents)



Source: Economist Intelligence Unit survey, 2011.



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the developed world down. At the same time, everyone was very optimistic that emerging markets would grow strongly. I think this year there's a bit more balance in all of that, particularly with growth from the US and Germany."

Respondents regard the US as a good source of potential growth, placing it fourth after Brazil, India and China in their list of the most growth-friendly markets (see chart 4). The Economist Intelligence Unit expects annual GDP growth in the US to average a relatively subdued 2.6% between 2011 and 2015. Although it faces a range of structural problems, including a sharp rise in public debt and high long-term unemployment, many investors are sanguine about the prospects for the US.

Dr Malmgren believes that a reduction in the wage differential between the US and emerging markets is helping to improve US competitiveness. "The US is much more able to produce competitive goods now, plus they have the additional power of brands that permit you to pass on higher costs," she says. "I think we are going to see that the US recovery surprises a lot of people."

In the short term, the most recent stimulus measures adopted in December 2010 could have an impact in helping to embed a stronger economic recovery in the US. As part of the package, the Obama administration extended all of the Bush-era tax cuts, and proposed a 2% reduction in payroll tax and a 100% tax deduction on purchases of businesses equipment in 2011. Mr Blacklock believes that this latter measure could be an important stimulus for economic recovery. "Many US companies are sitting on large amounts of cash and now have a very big incentive to bring forward capital expenditure into 2011," he explains. "If they bring forward two to three years' worth of capex into this year, this could have a substantial impact on growth in the US over the summer months, which, in turn, would increase growth rates for the global economy, at least in the short term. The concern, though, is that this may be like "cash for clunkers" [used-car exchange schemes introduced by many governments to stimulate post-crisis growth in the automotive industry]—a short-term boost to growth that will then fade."

Investors are far less confident about other developed markets. Just 8% of respondents think that Europe offers the best prospects for growth in the global economy, and only 6% have the same view about Japan (see chart 2). Although our survey was launched prior to the March 2011 earthquake, it is clear that the tragedy will have an impact on growth in Japan. Supply chains have been disrupted, and many large manufacturers have been forced to close factories. But in the longer term, growth will recover fairly strongly as reconstruction efforts get underway and as confidence returns.

Government finances in the developed world are not likely to improve significantly in the short term, according to Mr Urwin. "I do not believe this is the year in which we're going to see a meaningful shift in fiscal positions," he says. "To some extent, that's good, because it may just be too early for a global economy that is still fragile to cope with a synchronised fiscal tightening. At the same time, it's bad news, because at some stage we know that tightening is going to have to happen."

Indeed, respondents see government bonds as one of the most likely candidates for the next asset-price bubble, a concept that Jim Reid, credit strategist at Deutsche Bank, has called "The last chain in the rolling super-cycle of bubbles."



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# Diverging prospects for Europe

**T**he prospects for the Eurozone continue to diverge between the stronger core countries, such as Germany, whose increased strength in manufacturing and exports is feeding through into relatively strong GDP growth and consumer spending, and the much weaker countries around the periphery. In April Portugal became the third country, after Greece and Ireland, to request an emergency financial rescue package from the European Commission. And although EU policymakers have put in place a range of measures to protect the Eurozone, investor confidence in the region remains very weak.

The potential for Spain to join the list of countries in need of a bail-out is one that clearly troubles investors. "That would cause far greater stress than Ireland, Portugal or Greece, because of the interconnectivity of European sovereign debt within the banking system," says Craig Thorburn, a strategist at the Future Fund, an Australian investment entity. "Spain is a very large borrower and, as a result, a lot of institutions, banks, and governments hold Spanish paper."

At present, however, the prospect of Spain requiring emergency assistance appears relatively unlikely. Although it has larger financing needs than Portugal, its borrowing costs are under control and it has a lower ratio of public debt than other peripheral countries in the Eurozone. It has also had some success in restructuring its troubled cajas, or savings banks, and in tackling its fiscal deficit.

Spain may escape serious problems, but the prospect of default from one of the three countries that have already requested emergency funding cannot be ruled out. Indeed, almost half of respondents think that sovereign debt default in the Eurozone is a likely scenario (see chart 1). Greece is currently the main source of concern. In late March, Moody's Investors Service slashed Greece's sovereign credit rating by three notches, which suggests to some that default is virtually inevitable. In March, the yield on ten-year Greek bonds rose to a record 12.85%.

"The bulk of Greek debt is beyond its ability to pay and at some point they're either going to have to extend a lot of the maturities or expect investors to have to take a hair cut," says Scott MacDonald, senior managing director and head of credit and economics research at Aladdin Capital (US), a boutique investment banking firm.

How would investors react to a default? "I think the market is fully expecting it, to the point that it won't faze anybody," says Dr Malmgren. "My concern is that one debt rescheduling won't be sufficient. We're going to continue in a process of more rescheduling, which will cause the markets to get nervous, and then the same thing will happen over again. I expect that we've got a lot of volatility ahead of us."



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Although the likelihood of default has increased, few respondents expect that this will lead to a complete break-up of the Eurozone (see chart 1). Investors questioned for this research share this sentiment. “I am confident that the Euro will survive,” says Jonathan Lemco, principal and senior analyst in fixed income at Vanguard. “Despite the domestic opposition in Germany to helping out the laggards, ultimately I think Germany will do what it has to do to keep the Euro alive. It’s in Germany’s interest to keep it going, because it’s an export nation and because the collapse of the project would cause enormous costs for their financial sector.”



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# Political unrest hits economic prospects in the Middle East

**T**he political turmoil that has spread across the Middle East since the fall of the Tunisian government, engulfing Syria, Yemen, Bahrain and Libya, continues to cast a shadow over the global economy. Many respondents think that further political turmoil in the Middle East is a likely scenario (see chart 1).

Florence Eid, founder and chief executive of Arabia Monitor, agrees that there will be further volatility on the path to a new Middle East. "In the long run, a new Middle East will be born and I think it will be a better Middle East than we have had to live with in the past," she says. "But along the way there will be volatility and uncertainty, and fairly violent demands for more redistributive political regimes, as well as for greater economic and political rights."

This could have a dramatic impact on economic growth in the region. We expect that countries that have been most affected by unrest, such as Tunisia and Egypt, will experience a sharp near-term economic slowdown, owing to the disruption caused by large-scale strikes and a drop in tourism. In the most extreme case, Libya will experience a severe economic contraction this year, as the country slides into civil war.

Ms Eid expects that GDP growth for the region will fall by 50% for North African countries, and possibly even for the Gulf countries. "Many thought that 2011 would be the year of recovery for the Middle Eastern markets, but those hopes are now being dashed," she says. "Public markets are going to remain depressed throughout 2011 and I don't see a respite any time soon."

## Oil price surge: the fear effect and the Saudi factor

In addition to dragging down economic growth in the region, the unrest is also having an impact on oil prices. In the immediate wake of the unrest in Tunisia and Egypt, oil prices surged as markets reacted to fears that the unrest could spread to the major oil exporters in the Gulf, such as Saudi Arabia. The ensuing crisis in Libya caused another jump in prices as capacity equivalent to 1m barrels of oil a day of export capacity was shut down.

Although the major oil exporters have stepped in to increase capacity, ongoing political instability in the region is likely to keep prices high in the short term. Respondents to our survey consider it likely that prices will rise to US\$150 a barrel (see chart 1), although many commentators argue that it is fear, rather than a fundamental mismatch between supply and demand, that is driving the price increase. In essence, there is a risk premium being added to oil prices to compensate for the increased uncertainty that



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ongoing political instability has caused. “We need to see how this situation unfolds, but so far the price reaction has been caused by fear rather than an actual supply disruption,” says Nicholas Kwan, chief Asian economist for Standard Chartered (UK/SA). “That said, a price of US\$150 or more is a real possibility.”

Analysis by Standard Chartered suggests that an oil price of between US\$120 and US\$150 could take up to 1% from global growth momentum. And if oil prices rose to US\$200 a barrel, the impact would be considerably more severe. “Most of the world would be hit, and particularly Asia,” says Mr Kwan. “And if it stayed that high for two to three quarters, we would predict a high possibility of double-dip recession.”

One factor that could easily cause a price increase on that scale is the spread of unrest to Saudi Arabia. Political instability in the world’s leading oil producer, which accounts for around 25% of global output, could have a severe impact on both oil prices and economic growth. “If the unrest spreads to Saudi Arabia, there would be demand destruction because people won’t be able to carry on with normal economic activities if the oil price is two or three hundred dollars a barrel. That would be extremely negative for all risk assets.”

So far, protests in Saudi Arabia have been relatively subdued. There have been some demonstrations, but the country’s rulers have responded with a pledge to foster national dialogue and a large increase in finance for measures aimed at delivering better living standards. These steps, along with periodic displays of force from the security services, are likely to ensure that Saudi Arabia remains stable. “The Saudis are making promises and commitment to change,” says Mr Lemco. “So long as that remains true, and so long as external pressures on Saudi Arabia don’t become overwhelming, my best guess is that they’ll be able to contain the situation.”

The implications of the Arab Spring could be felt even further afield. Mr Denison argues that other “stagnant political regimes” are at risk of suffering a similar fate as countries in the MENA region. “You could see something similar happening in Central Asia or parts of sub-Saharan Africa, where you get a similar form of political and institutional decay,” he explains. “Stagnant political regimes that revolve very much around individual leaders and a very close family circle are potentially at risk anywhere in the world.”

The lesson for investors is that they need to look more closely at regimes that may outwardly appear stable, but that have many social and economic problems that remain unaddressed. Technology and the spread of ideas through globalisation is exerting a powerful impact and serving as a catalyst for change. Overall, respondents to our survey consider it extremely likely and beneficial that the Internet and social networking are serving as a catalyst for political change (see chart 1). “As people around the world become more interconnected and less atomised, they are becoming more aware of the freedoms that they don’t have,” says Mr Lemco.



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# Policy divergence

A post-crisis divergence in economic prospects and growth rates is encouraging a deviation of policy responses from governments and central banks. Many fast-growing emerging markets have tightened monetary policy over the past few months. In March, Brazil raised its benchmark overnight rate by 0.5% to 11.75%, making it among the highest in the world. The Chinese premier, Wen Jiabao, has also promised to tackle inflation, which he described as a tiger that “once set free, will be very difficult to put back into its cage”. Beijing has repeatedly raised the amount banks must hold on reserve with the People’s Bank of China (PBC, the central bank) over the past year and increased interest rates four times in the past five months.

The developed countries, on the other hand, have been more reluctant to raise interest rates; many are worried about the prospect of undermining their fragile economic recoveries. The Fed has held rates at 0-0.25% for 27 months. The UK has held its rate at 0.5% for two years, although inflation is now 4%. Only the European Central Bank has made steps to tighten monetary policy, lifting its main interest rate from 1% to 1.25% in April, the first time it had made such a move since 2008.

This divergence in policy is also reflected in an increasing difference of opinion at a multilateral level. When the inaugural G20 meeting was held in Washington in November 2008, it seemed to herald a transition to a more representative model of international governance. Gone was the elitism of the US-dominated G7, the “rich man’s club” of major advanced economies, and in its place was a much broader, more inclusive group of both developed and emerging economies, including Brazil, India and China.

The G20 got off to a good start. With considerable unanimity of purpose, the leaders of the world’s 20 largest economies agreed a set of fiscal and expansionary measures, increased funding for the IMF and proposed new rules to regulate financial institutions. But the spirit of consensus was not to last. Indeed, the failure of the March 2011 G20 meeting in Nanjing to achieve agreement on serious reform of currency and economic imbalances, suggests that multilateralism may be on the wane. In a recent article in *Foreign Affairs* magazine, Nouriel Roubini and Ian Bremmer went so far as to suggest that we are now living in a G-Zero world, in which there is no single country in a position to exercise global leadership.

Respondents to our survey share some of this pessimism. In general, they have low expectations about the potential for progress on key multilateral policy issues. Few consider it to be likely that the Doha round of trade negotiations will reach a conclusion, and few expect agreement on a global accord to replace the Kyoto Protocol. And despite early progress from the G20 on co-ordinating reform of the



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financial sector, the chances of a globally agreed solution to the “too-big-to-fail” problem are also seen as slim (see chart 1).

Whereas the financial crisis brought the world’s major economies together, the recovery is driving them apart. With the worst of the financial crisis now behind them, countries are focusing on their own domestic issues, or forming alliances with like-minded economies, rather than building a consensus on a multilateral basis. “Not only do you get individual states seeking to protect their industries or their potential for economic development, but also regional alliances constructed by states at a similar level of economic development to work in alignment,” says Mr Denison.

Multilateral decision-making is inherently challenging but, as the early G20 meetings demonstrated, it can also be effective. Respondents to our survey agree that progress on these issues would be beneficial. To achieve change, countries need to show patience and avoid retreating into a unilateral or bilateral stance on key global issues. “I think leaders need to recognize that it can take a long time for multilateral institutions and processes to evolve and work,” says Mr Denison. “It takes time for states to understand that maybe what doesn’t appear to be in their short-term interest will work for them in the longer term.”



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# A mixed outlook for the financial sector

**T**he past three years have been a grueling and turbulent period for the financial services sector. After the initial shock of the financial crisis, many institutions have been hit by huge losses, bankruptcies, bail-outs and nationalisation. The reputation of the sector has taken a significant knock, with banks facing intense public censure and criticism over their role in the financial crisis. This has spilled over into a strong political will to tighten regulation and place the industry under more intense scrutiny. Regulatory issues related to the banking industry are now at the heart of national and international policy agendas.

Over the past year, banks in key markets have staged a strong recovery. In the UK, for example, the financial services sector has seen nine months of solid growth with financial firms reporting that business is nearly back to normal after the financial crisis. In the US, bank profitability has, for the most part, returned to pre-crisis levels and the Fed recently gave permission for the four largest US banks (with the exception of Bank of America) to resume or increase dividend pay-outs. And although European bank performance has been mixed, there are also signs of stabilisation. In early April, Commerzbank presented plans to repay €14.3bn (US\$20.5bn) of capital to the German government.

Some governments may now be considering an exit from their forced investments in the banking industry. Earlier this year, there were rumours that UK Financial Investments, the entity that manages the government's stakes in the UK banking industry, might be considering a part-sale of RBS. In general, respondents consider it fairly unlikely that governments will sell off their remaining stake in the financial sector (see chart 1). But if this were to happen, they think that it would have a positive impact on their portfolio.

"Governments should not be in the business of owning private enterprise," says Mr Demeroutis. "I think what governments have done in terms of rescue and support has been right, but now these companies should be returned to the private sector. It needs to be done calmly, with discipline and without disruption."

Looking to the future, respondents generally view the prospects for the financial services sector as positive. Investment banking, in particular, is seen as having a bright outlook (see chart 14). "I think that makes perfect sense," says Marc Hendriks, chief investment officer at Sand Aire (UK), a multi-family office. "Investment banks are a leveraged play on economic growth and perform a fundamental role as a capital-raising mechanism for the economy. And there is going to be a lot of that needed."

In addition to their role as an intermediary in the capital-raising process, investment banks also earn a substantial chunk of their revenue from advising on M&A transactions. Although M&A activity has been in the doldrums for the past three years, there are signs of a pick-up in volumes. According to mergermarket, an independent analysis firm, global M&A activity rose by almost 19% in dollar terms in the first quarter

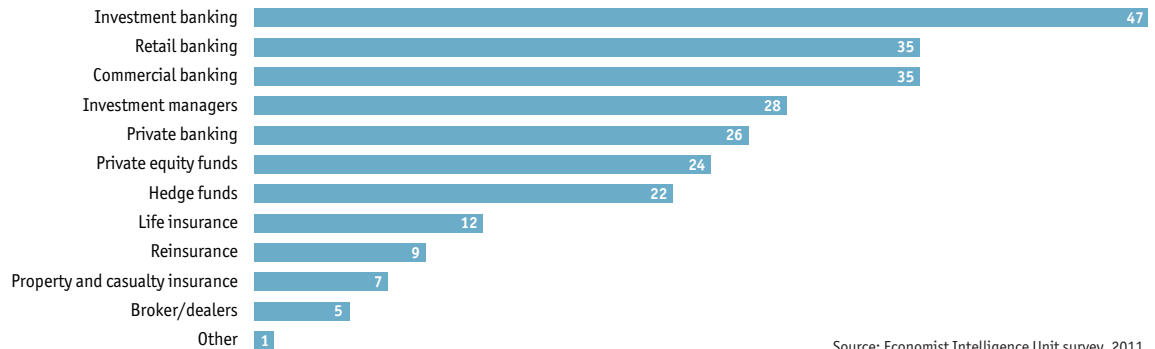


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Chart 14 **Which of the following sub-sectors of financial services do you think offer the best opportunities for revenue growth?**

(% respondents)



Source: Economist Intelligence Unit survey, 2011.

of 2011, compared with the same period in 2010. With companies coming through the crisis in a cash-rich position, a growing number are looking to acquire as a means of securing growth.

The return of M&A will be good news for the investment banks. “Over a 12-month time horizon, we would argue that there’s the potential for considerable M&A activity, given all the cash on corporate balance sheets,” says Mr Thorburn. “I would say that the stars seem somewhat aligned for investment banking and that 2011 could be a very good year.”

But the good times are likely to be short-lived. Impending regulation, including the Dodd-Frank Act in the US and Basel III, is likely to reduce profitability and return on equity by forcing investment banks to hold more capital, reduce leverage and hive off profitable, but risky, proprietary trading desks. But even this may not make a huge difference; respondents think it fairly unlikely that new regulation will cause a dramatic drop in profitability (see chart 1).

Banks themselves have been vocal about the impact of regulation on their sector. In the US, JPMorgan chief executive, Jamie Dimon, recently warned that new capital rules could be “The nail in the coffin for big American banks.” And Peter Sands, chief executive of Standard Chartered, said that the biggest external challenge his bank faced was regulation.

Although the banking industry succeeded in pushing back implementation of the Basel-III requirements until 2019 on the grounds that earlier action could have an adverse impact on the economy, many investors say that there will still be an impact. “I am worried about ongoing re-regulation of the financial services sector,” says Mr Thorburn. “We take the view that, coming out of the crisis, any push from a deregulatory environment to a re-regulatory environment is an absolute headwind when it comes to investment returns.”

Respondents may think that investment banks have good short-term prospects, but the same cannot be said for insurance companies. A swathe of natural and man-made disasters has had a dramatic impact on the industry. According to Swiss Re, the global cost of natural and man-made disasters more than tripled in 2010 to US\$218bn, compared with the previous year. The recent earthquake and tsunami in Japan will compound the problems, especially for reinsurers.



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# Conclusion

**F**inancial markets are not always good at pricing the impact of unlikely scenarios. The traditional tools for managing risk tended to assume a range of scenarios that was too benign and short-term. Extreme events, such as the collapse of the sub-prime mortgage market and ensuing financial crisis, did not figure in most investors' probability distributions.

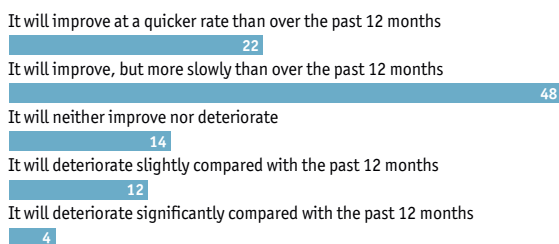
As the global economy emerges from crisis, there are plenty of factors that could affect growth on both the upside and the downside. Long-term structural trends, such as the rise of emerging markets, are all but certain to continue on their path. But there may be bumps along the way, including bubbles forming in some asset classes and the potential for some developed markets to surprise with the strength of their recovery. Much will depend on the actions of policymakers. With emerging markets forced to tighten policy to control inflation and most developed economies favouring a loose approach, there is considerable potential for policy actions to exaggerate or cancel out trends that are already underway.

For investors and corporations, these remain uncertain times in which ongoing vigilance will be essential. Asset selection will become more important than it was earlier in the recovery, when investors were better able to take advantage of the performance of a broad set of asset classes. And although there remain risks that could derail any incipient recovery, this remains an environment in which there are considerable opportunities for knowledgeable investors.

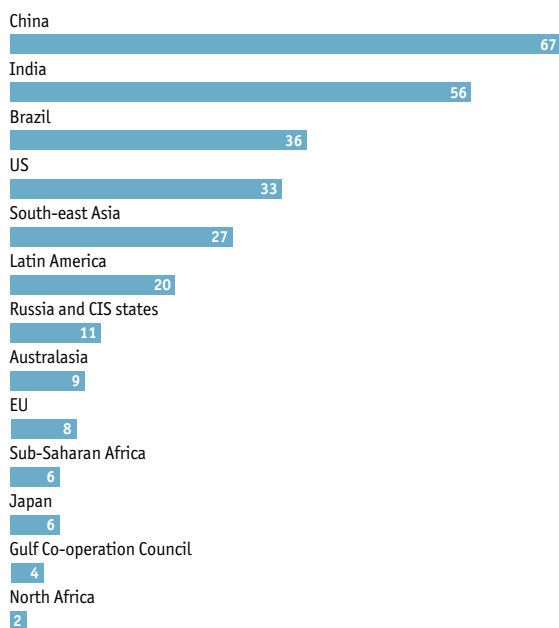
## Appendix: Survey results

Percentages may not add to 100% due to rounding or the ability of respondents to choose multiple responses.

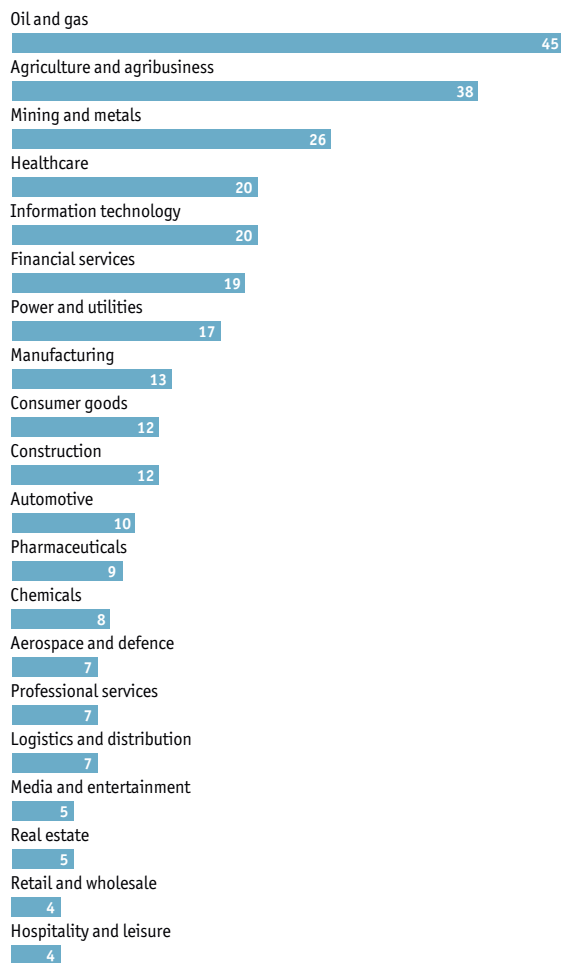
**Which of the following statements best expresses your view on the outlook for the global economy over the next 12 months?**  
(% respondents)



**Which three countries/regions of the world do you think offer the best prospects for economic growth over the next 12 months?** Select up to three.  
(% respondents)

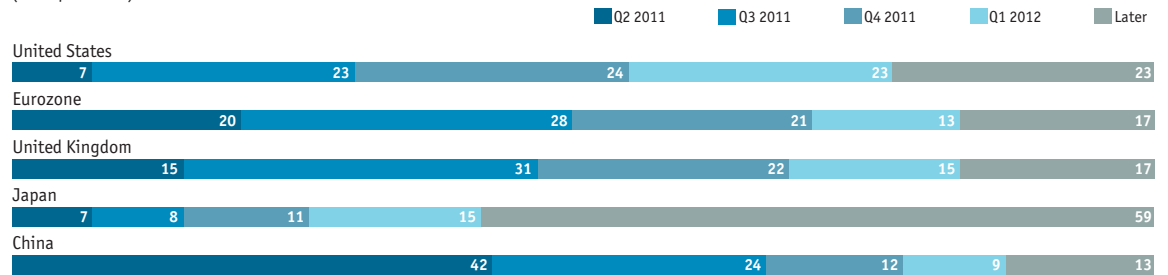


**Which of the following industries do you think offer the best opportunities for revenue growth over the next 12 months?** Select up to three.  
(% respondents)



**When would you expect headline interest rates to be raised in the following regions or countries?**

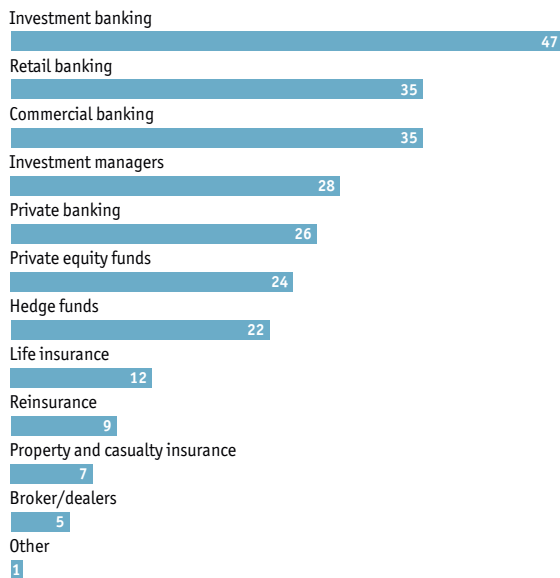
(% respondents)



**Which of the following sub-sectors of financial services do you think offer the best opportunities for revenue growth?**

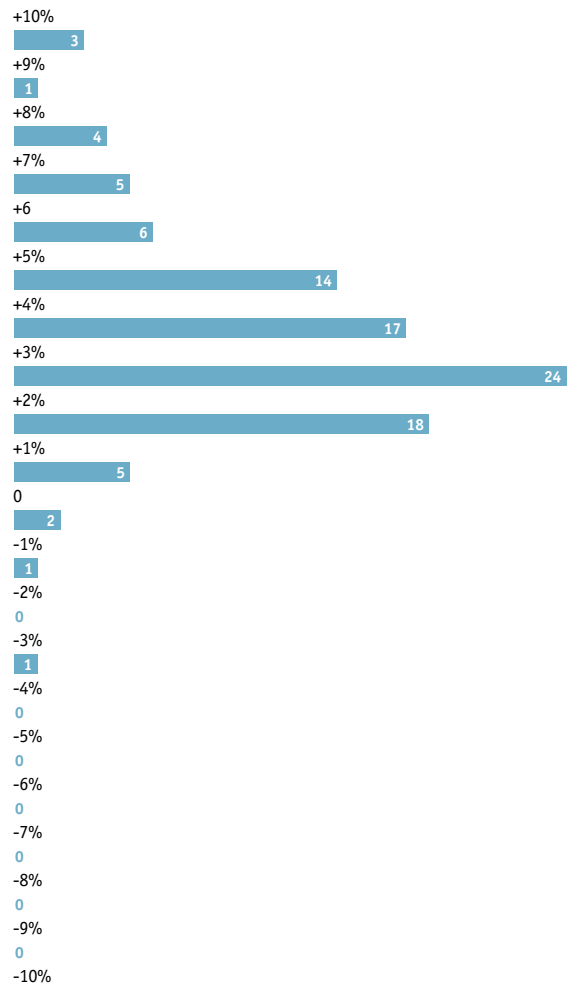
Select up to three.

(% respondents)



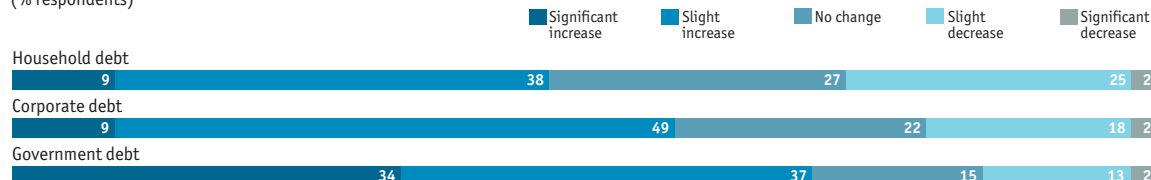
**On average, what is your expectation for the level of consumer price inflation in the market in which you are personally based over the next 12 months?**

(% respondents)



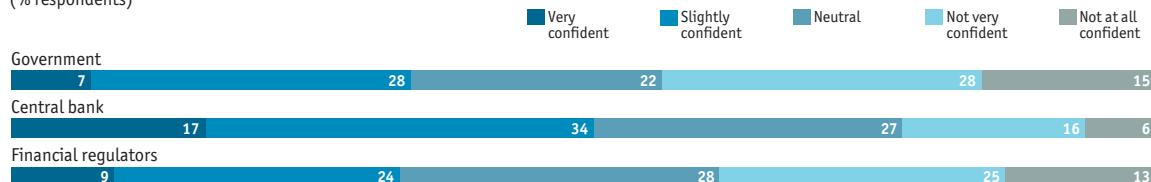
**Over the next 12 months, what change do you expect to debt ratios across the following categories in your domestic market?**

(% respondents)



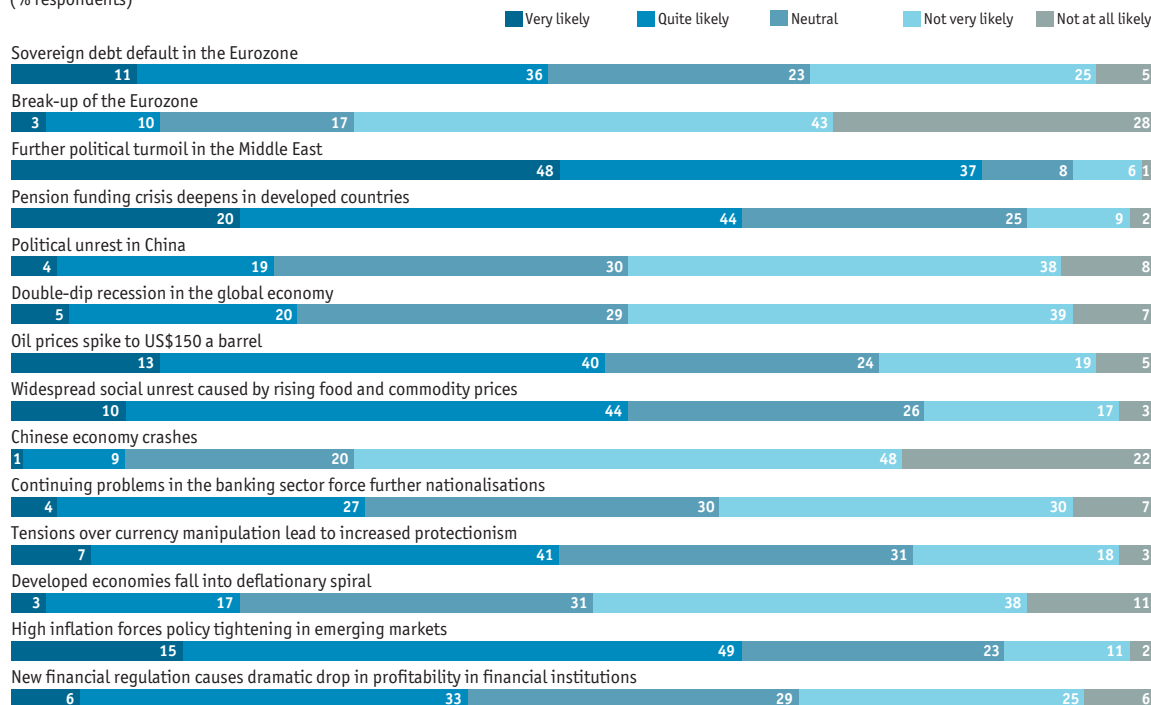
**How confident are you in the abilities of the following administrations to make the right decisions to ensure strong performance in your domestic economy over the next 12 months?**

(% respondents)



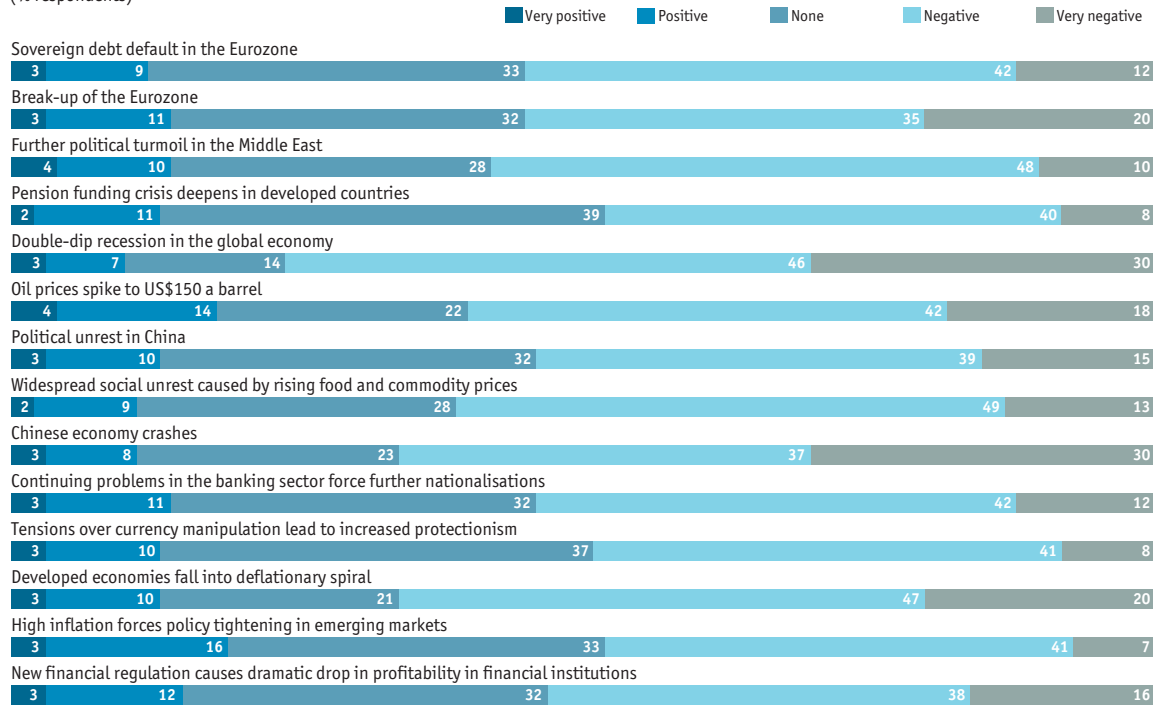
**Over the next 12 months, what assessment would you give to the likelihood of the following scenarios taking place?**

(% respondents)



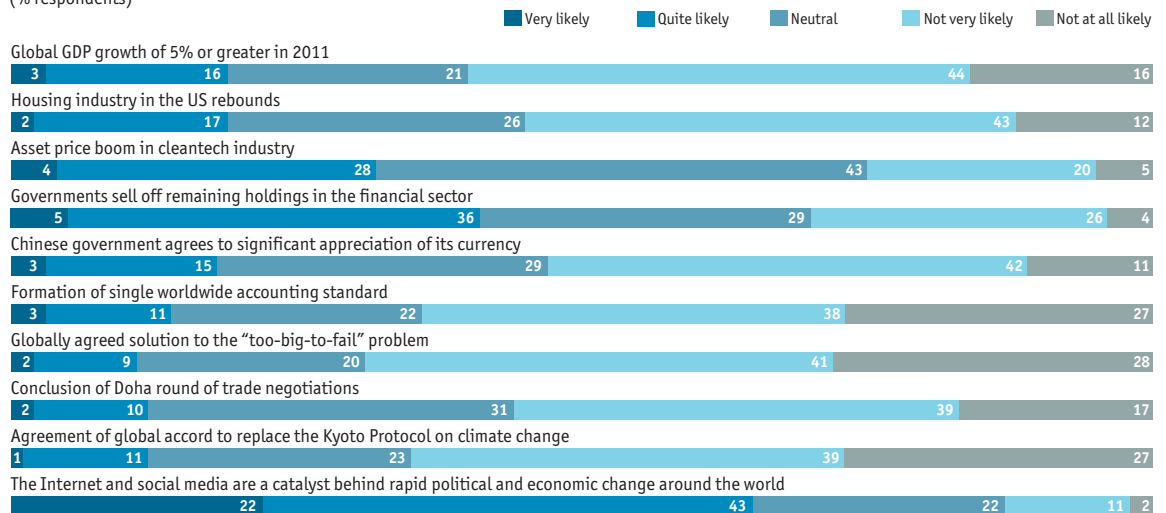
**If the following scenarios were to take place, what impact do you think they might have on your portfolio/business?**

(% respondents)



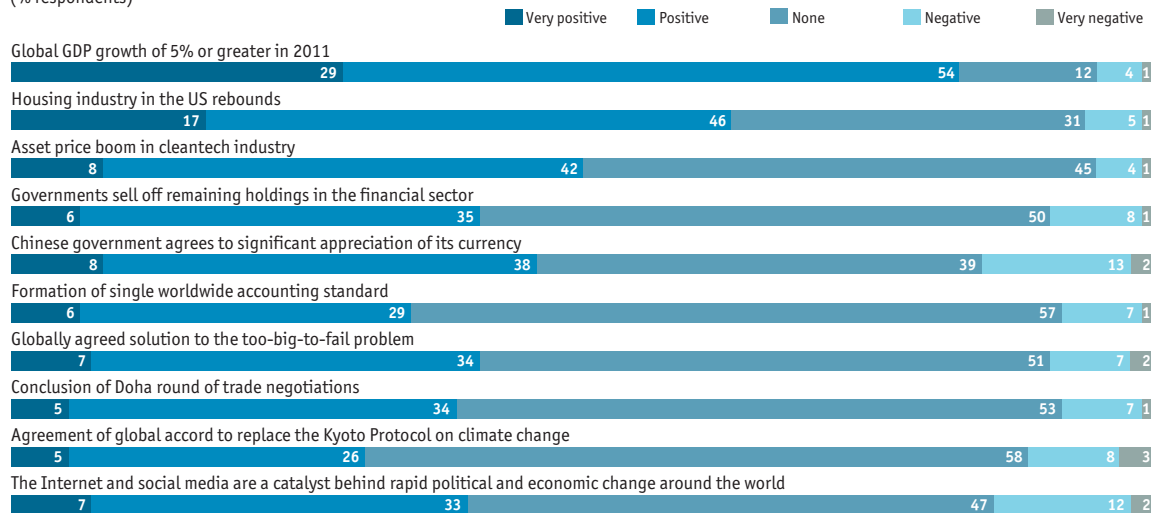
**Over the next 12 months, what assessment would you give to the likelihood of the following scenarios taking place?**

(% respondents)



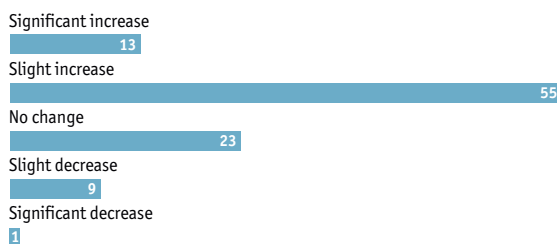
**If the following scenarios were to take place, what impact do you think they might have on the overall value of your portfolio?**

(% respondents)



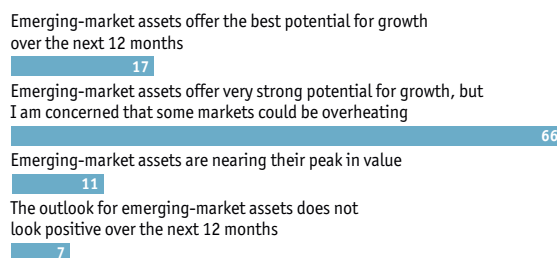
**Over the next 12 months, what change do you expect in overall levels of volatility in your domestic financial market (ie, the country in which you are based)?**

(% respondents)



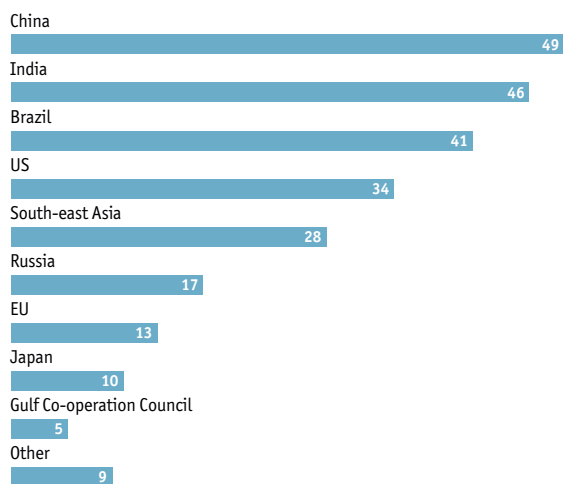
**Which of the following statements best expresses your view of investing in emerging-market assets (eg, BRIC countries)?**

(% respondents)



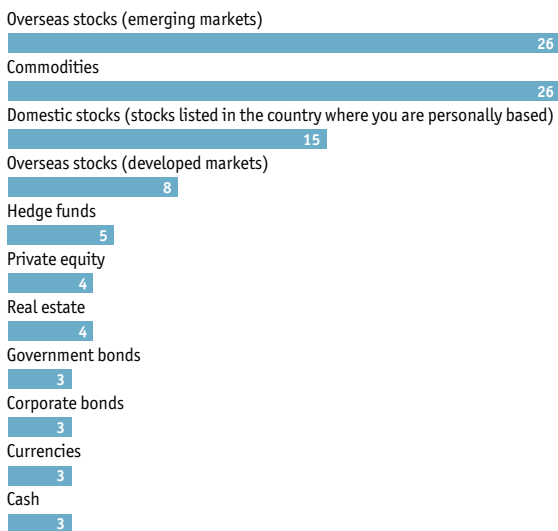
**Which of the following regions and countries of the world do you think offer the best potential for asset price growth over the next 12 months? Select up to three.**

(% respondents)



**Over the next 12 months, which of the following asset classes do you think will perform most strongly?**

(% respondents)



**In your view, where is the next asset price bubble most likely to form?**

(% respondents)



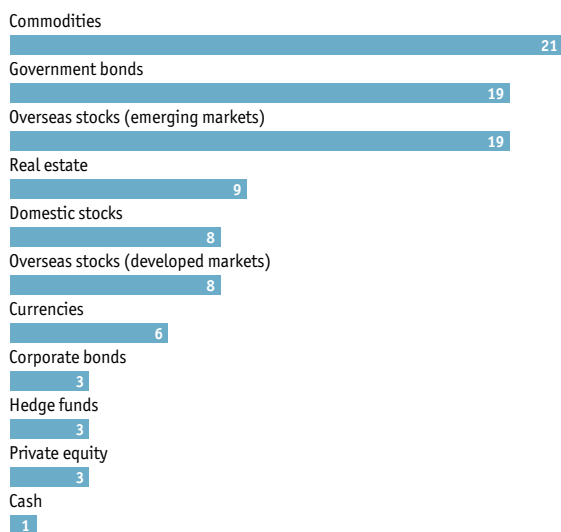
**Which of the following statements best expresses your view about current growth opportunities in the financial markets?**

(% respondents)



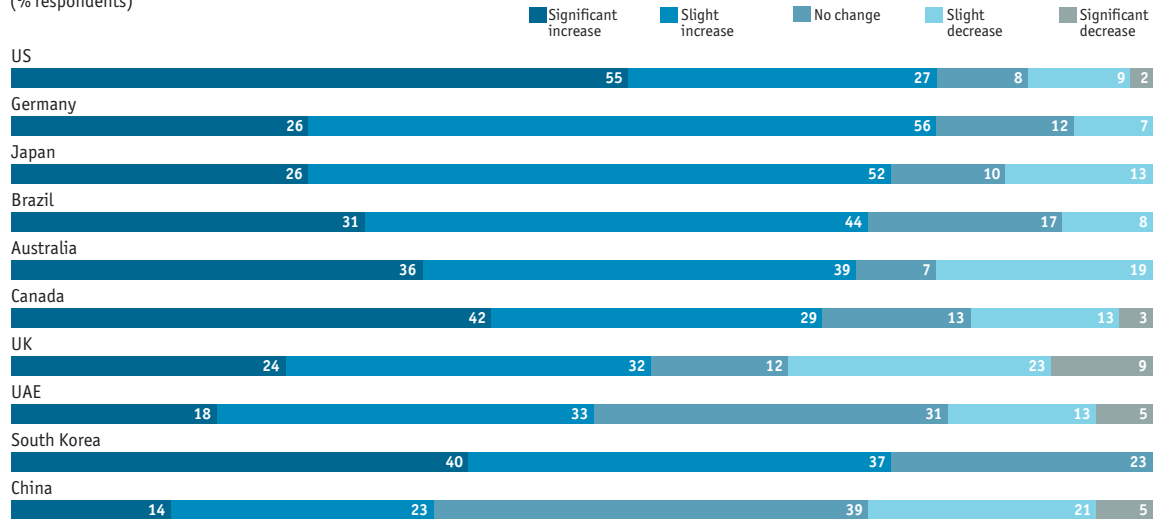
**Which of the following asset classes do you think are most likely to increase in level of risk over the next 12 months?**

(% respondents)



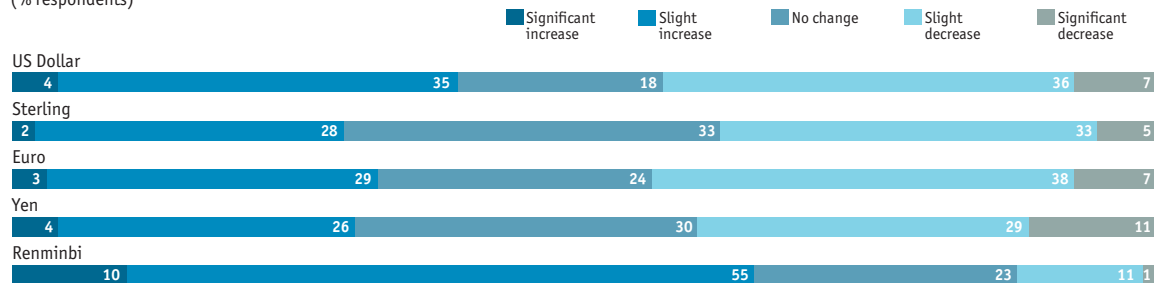
**Over the next 12 months, what change do you expect to government debt ratios across the following categories in your domestic market?**

(% respondents)



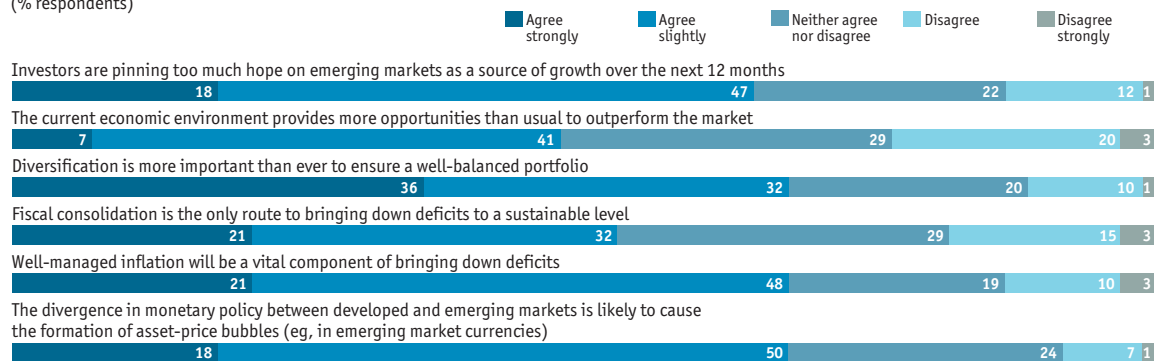
**Over the next 12 months, what change do you expect to the value of the following currencies?**

(% respondents)



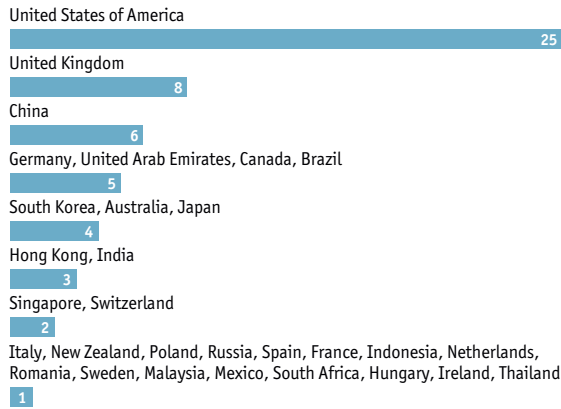
**Please indicate whether you agree with the following statements.**

(% respondents)



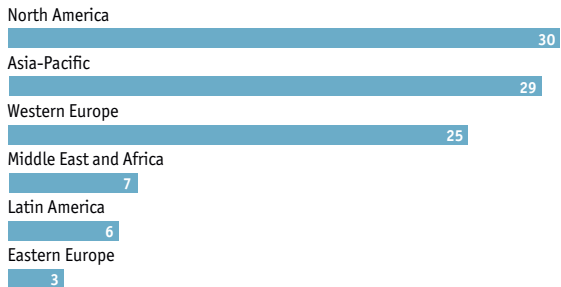
**In which country are you personally located?**

(% respondents)



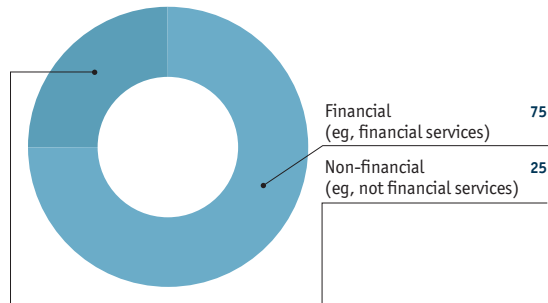
**In which region are you personally based?**

(% respondents)



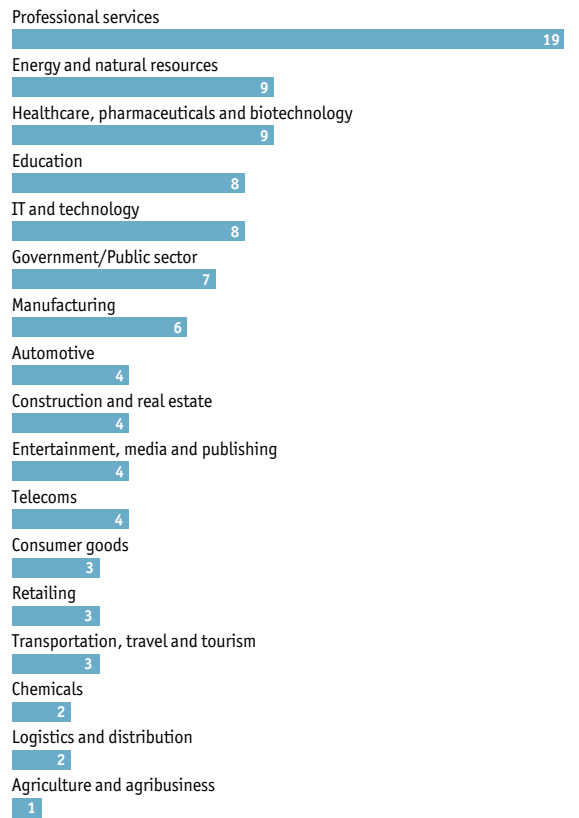
**What type of organisation do you work for?**

(% respondents)



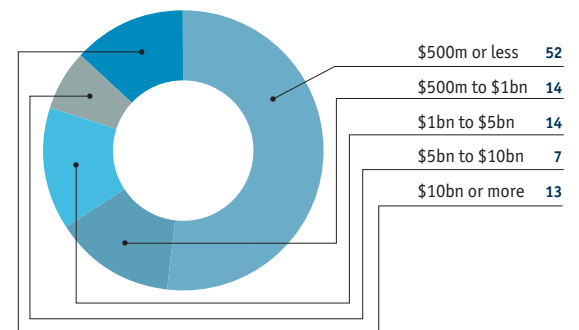
**What is your primary industry?**

(% respondents)



**What are your company's annual global revenues in US dollars?**

(% respondents)



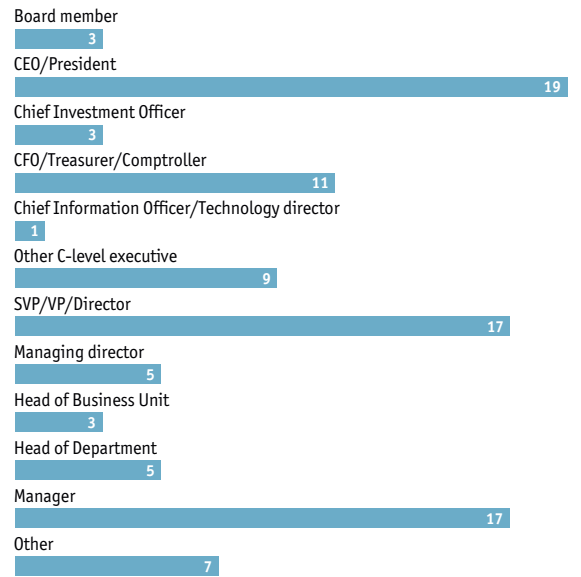
**In which subsector of financial services does your organisation primarily operate?**

(% respondents)



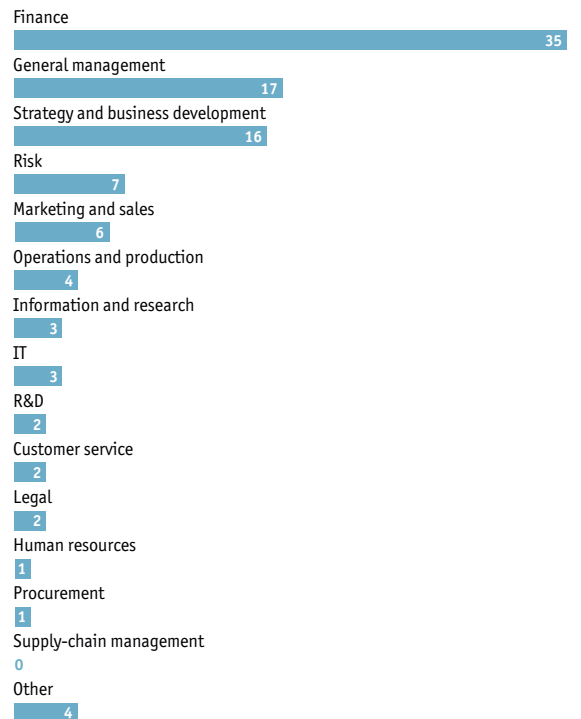
**Which of the following best describes your job title?**

(% respondents)



**What is your main functional role?**

(% respondents)



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