CITY OF LONDON
Investment Management Company Limited

Global Developed Markets Economic Outlook

Fourth-Quarter 2011 Forecast

November 2011

United States and Canada: US Economy Gains Traction, but Confidence Fragile

Better-than-expected gross domestic product (GDP) data released in late October by the US Commerce Department that show the American economy grew at an annualised rate of 2.5% in the third quarter of this year, the fastest pace of expansion since the same quarter of 2010, have helped calm fears that the world's largest economy may be slipping into recession. Growth in the three months to end-September was led by fixed investment by businesses, which contributed 1.7%, and consumer spending, which added 1.5%, while a decline in business inventories knocked 1.1% off growth. Business investment picked up strongly, with real non-residential fixed investment increasing by 16.3%, from 10.3% in the previous quarter. Investment in equipment and software grew by 17.4%, at an annualised rate, though spending on both residential and non-residential construction slowed in the third quarter.

Consumer spending grew at an annualised rate of 2.4%, following a 0.7% rise in the previous quarter. American consumers increased spending on durable goods after paring back in the second quarter, while spending on non-durable goods and services also rose. US retail sales rose by 1.1% in September, their fastest pace in seven months and by 7.9% year on year, boosted by a 3.6% gain in motor vehicles and auto parts sales from the previous month. Consumption was boosted primarily, however, by a drop in the household savings rate from 5.1% to 4.1% of disposable income, at a time when personal income growth is stagnating against the backdrop of a soft labour market. Non-farm real average weekly earnings fell by 0.8% month on month in August and by 1.8% year on year.

Overall, therefore, third-quarter GDP data suggest that the pace of US economic activity, though exceeding most forecasts and almost double that of the second quarter, is still too slow to absorb excess capacity and create enough new jobs to bring down unemployment, still stubbornly high at 9.1% in September, unchanged from August, according to the US Bureau of Labour Statistics, while the monthly payroll survey also showed total employment remained unchanged at 131.1 million in August.

State and municipal governments continued to rein in spending in the third quarter, with both expenditures and investment declining by 1.3%, compared with 2.8% in the prior quarter. Further planned budget cuts by states and municipalities are expected to bring more job losses in the fourth quarter, after state and local governments subtracted 0.2 percentage points from growth in the third quarter. Industrial output rose by 0.2% in September from the previous month and by 3.2% from a year earlier. In the same month, the International Monetary Fund (IMF) lowered its forecast of US GDP growth this year by one percentage point, to 1.5%.

Real GDP Growth Forecasts for the G7 Economies (% change over a year ago)

	2010	2011F	2012F
United States	3.0	1.7	1.5
Canada	3.2	2.2	2.2
Japan	4.0	-0.6	1.9
Euro area	1.7	1.6	-0.5
-Germany	3.6	2.8	0.2
-France	1.4	1.6	-0.1
-Italy	1.2	0.5	-1.2
United Kingdom	1.8	0.9	0.7
Global developed markets	2.6	1.3	0.9

F is forecast.

Source: J P Morgan, October 2011

While the latest quarterly GDP data have been welcomed by investors, and sentiment buoyed also by generally well-received third-quarter company earnings announcements that show the US corporate sector in robust health, there is growing concern that net exports have not made a significant contribution to growth, while further planned reductions in federal government expenditures will make it increasingly difficult for the economy to sustain the third-quarter's pace of expansion in coming quarters.

External Account Data for the G7 Economies

	Trade Balance latest 12 months (US$bn)	Current-Account Balance latest 12 months (US$bn)	Current-Account Balance as % of 2011 GDP (F)
United States	-711.1 (Aug)	-469.9 (Q2)	-3.3
Canada	-5.3 (Aug)	-53.4 (Q2)	-2.9
Japan	20.6 (Aug)	153.3 (Aug)	2.4
Euro area	-33.0 (Aug)	-99.0 (Jul)	-0.5
-Germany	197.8 (Aug)	192.3 (Aug)	5.1
-France	-93.1 (Aug)	-63.5 (Aug)	-2.5
-Italy	-49.3 (Aug)	-81.9 (Aug)	-3.7
United Kingdom	-158.3 (Aug)	-70.4 (Q1)	-2.0

F is forecast.

Source: The Economist, October 2011

Housing activity continues to suffer from the effects of a soft labour market, showing little improvement in the third quarter. US house prices rose for a fourth consecutive month in July, 0.9%

higher from June, according to the Standard & Poor's/Case-Shiller index of house prices in the 20 largest American cities, but were still 4.1% lower than a year before. With sales of new homes falling to a six-month low in August, after dropping for the fourth time in as many months, a strong recovery in the housing market is still nowhere in sight.

Inflation, meanwhile, remains stubbornly high, rising to an annualised rate of 3.9% in the year to September, a two-year high, and up from 3.8% in August, and 3.7% in July. Consumer prices rose by just 1.1% year on year in September 2010. Lingering doubts about the sustainability of the economic recovery, however, meant that the Federal Reserve continues to hold short-term interest rates at emergency-low levels, with the fed funds overnight target rate unchanged throughout the third quarter in a narrow range of 0% to 0.25%. At the same time, at its September policy-making meeting, the Federal Open Market Committee, unusually, made explicit its intention to keep the fed funds rate at exceptionally low levels until at least mid-2013, given its forecast of subdued inflation over the medium-term.

Consumer-Price Inflation Forecasts for the G7 Economies (% change over a year ago)

	4Q2010	2Q2011	4Q2011F	2Q2012F
United States	1.2	3.3	3.2	1.4
Canada	2.3	3.4	2.6	1.6
Japan	-0.3	-0.4	-0.1	-0.7
Euro area	2.0	2.8	2.8	1.6
-Germany	1.6	2.5	2.6	1.6
-France	1.9	2.2	2.3	1.3
-Italy	2.0	2.9	3.7	2.6
United Kingdom	3.4	4.4	4.9	2.8
Developed markets	1.5	2.7	2.7	1.3

F is forecast.

Source: J P Morgan, October 2011

With the sustainability of the economic upturn in doubt, however, and scope for additional monetary stimulus extremely limited, the Democrat administration in Washington is pinning its hopes on a short-term fiscal stimulus combined with a medium-term plan to rein in the budget deficit once the economy gains traction again. For President Obama, seeking re-election in November 2012, the problem is that, while the Republicans remain steadfastly opposed to any kind of tax increase to shrink the budget shortfall, the Democrats, who in October proposed to reduce the deficit by $3,000bn, will reject outright any plan consisting solely of spending cuts.

Given that America's two main political parties remain at loggerheads, the prospect of another debt showdown is looming, along with the probability of a second credit rating downgrade of the federal government, following Standard & Poor's (S&P) first ever downgrade of the country's rating, to AA+, on August 5. But while there is growing pressure for government spending cuts, the fragility of the economic recovery argues against drastic expenditure reductions at present. The Congressional super committee formed in August as part of the federal government debt ceiling deal must come up with details of the $1,200bn of promised spending cuts, equal to almost 5% of annual discretionary government spending, by late November. If agreement on where the spending axe will fall cannot be reached in time, or if a deal is not approved by December 23, then an equal amount of reductions in discretionary spending over a decade, half of it to defence, will automatically take effect.

Canada's economy continues to gain traction after a weak patch in this year's second quarter, but second-half performance will be largely determined by the trends south of the border and by declining commodity prices, which have pushed the Canadian dollar back above parity with its US counterpart in recent weeks on a spike in investor risk aversion. Latest data show the economy contracted by 0.4% quarter on quarter at an annual rate in the three months to June, but grew by 2.2% from the same period of 2010.

Unlike the US, however, Canada retains the policy flexibility to cut interest rates – the central bank has held its overnight rate at 1% since September 2010 – while there is also scope for a more expansionary fiscal policy, with the public-sector deficit at a manageable 5% of GDP and a lower debt ratio than in most of its developed country peer group. Beyond the anticipated second-half rebound in economic activity, however, there are concerns about the sustainability of the recovery in 2012, given the below-trend growth forecast for the US next year, a market that absorbs more than three quarters of Canada's exports, concentrated in the auto and housing sectors. Falling prices for Canada's main export categories will negatively impact the country's terms of trade and cut incomes.

After September saw the creation of 61,000 full-time positions, reducing the unemployment rate to 7.1%, the lowest rate since December 2008, October unexpectedly saw 54,000 jobs lost, with the economy adding a meagre 1,400 jobs in the past three months. Headline consumer-price inflation (CPI) rose sharply to 3.1% year on year in August, up from 2.7% in July, but core inflation, at 1.9% year on year, is marginally below the Bank of Canada's 2% target rate, and is expected to edge lower in coming months helped by favourable base effects. With household debt being underpinned by rising house prices, and overall private-sector credit growth rising at an underlying rate of 5% annually, Canada still compares favourably with its peer group countries, also a reflection of the relative strength of its banking sector, which proved impressively resilient to the global financial crisis. Continued slack in the Canadian economy and a relatively subdued 12-month growth outlook, however, suggest that GDP growth will soften in the second half of 2011 and 2012, but outright recession should be avoided.

United Kingdom: Recession Risks Rising as Inflation Soars

Concerns that the UK economy may be about to slip into recession again have been allayed, temporarily, by the release of marginally better-than-expected third-quarter 2011 GDP data showing output grew by 0.5%, in both quarter-on-quarter and year-on-year terms, exceeding market expectations of a 0.3% expansion, while the economy grew by 0.6% over the six months to September and by 0.5% over the year to September. GDP growth in the second quarter was revised down to 0.1% quarter on quarter, lowering growth to just 0.6% in the year to the second quarter.

Third-quarter growth was driven mainly by the services sector, whereas construction output contracted slightly. Prospects for the manufacturing sector have deteriorated, reflected in a steep fall in the Markit/CIPS UK Purchasing Managers' Index (PMI) in October, to 47.4, the lowest reading since September 2009, from a downwardly revised 50.8 in the previous month, crossing from expansion to contraction. New orders, meanwhile, contracted at the fastest pace since March 2009, with both domestic and export orders declining as companies run down inventories. If the corporate sector now scales back investment and capital spending, there is little to underpin growth, particularly as the Conservative/Liberal Democrat coalition government appears intent on pressing ahead with public spending cuts, in the face of mounting criticism that the pace of spending cuts is too fast given the economy's underlying weakness. UK house prices in nominal terms, meanwhile, appear to lack any clear direction, but continue to fall sharply in real terms, with no realistic prospect of recovery any time soon.

In common with much of the developed world, Britain's lacklustre economic recovery has failed to bring about an improvement in labour-market conditions. On the contrary, the UK's unemployment rate rose to 8.1% in the three months to August, while youth unemployment, at 21.3%, is the highest recorded in the UK. The number of unemployed rose to a 17-year high of 2.57 million. Employers remain reluctant to hire given the worsening outlook for Britain's economy. Responding to the worsening growth outlook, the Bank of England, in October, sharply reduced its fourth-quarter 2011 growth forecast to "close to zero", from its previous forecast in August of 0.4% growth.

Interest Rates and Unemployment in the G7 Economies

	3-month interest rates, latest (%)	10-year government bonds, latest (%)	Unemployment Rate (%)
United States	0.15	2.16	9.1 (Sep)
Canada	0.87	2.45	7.1 (Sep)
Japan	0.15	1.02	4.3 (Aug)
Euro area	1.58	2.05	10.0 (Aug)
-Germany	1.58	2.06	6.9 (Sep)
-France	1.58	3.20	9.9 (Aug)
-Italy	1.58	5.90	7.9 (Aug)
United Kingdom	1.00	2.47	8.1 (Aug)*

*F is forecast. *Latest three months.*

Source: The Economist, October 2011

Britain's CPI index rose to 5.2% year on year in September, up from 4.5% in August, and compared to the central bank's medium-term inflation target of 2%. CPI has never been higher since it was first calculated in 1996, and only once equalled this figure, in September 2008, while the retail price index in September rose 5.6% from a year earlier, the highest since June 1991. Producer-price inflation also accelerated to 6.3% year on year in September, up from 6% in August.

Worries about rising inflation, however, will continue to take a back seat to fears that the British economy is at significant risk of stalling, given the deteriorating outlook for the euro-zone economy, which is struggling to stop the spread of its sovereign-debt crisis and is the main market for the UK, accounting for two-fifths of exports. Neither is Britain's exposure to the euro area confined to trade. UK banks have significant lending exposure to the five countries on the periphery of the single currency area, with loans to Greece, Ireland, Italy, Portugal and Spain amounting to £220bn, according to latest data from the Bank for International Settlements, one tenth of which is public debt. British banks' claims on Ireland are equal to 5.9% of UK GDP, followed by Spain (4.2%), Italy (3.1%), Portugal (1.1%) and Greece (0.5%), amounting to 14.8% of GDP in total, marginally larger than Germany's exposure.

Monetary policy is proving ineffective at reviving Britain's economy. The Bank of England has held base rate unchanged at just 0.5% since March 2009, when it last adjusted its key policy interest rate. With the bank insistent that inflation will ease back toward its medium-term target over the next two years, no change in base rate is expected in the fourth quarter, or in 2012. In an attempt to offset the effects of slower growth in UK government spending, the central bank, in October, decided to inject another £75bn into the economy by purchasing gilts over the next four months, in the second phase of its quantitative easing, or asset-purchase, programme, lifting the total to £275bn, so far.

A gloomy outlook for the UK economy presents the coalition government with an unfavourable backdrop to the Chancellor's autumn statement; although the impact of the fiscal squeeze on economic growth is greatest in 2011, its effects will be only slightly less severe over the next two years, with real earnings growth set to stay negative in 2012, weighing on household spending.

Japan: Noda Replaces Kan as Reconstruction Delays Persist

Following two rounds of leadership votes, in August, the ruling Democratic Party of Japan (DPJ) chose Finance Minister Yoshihiko Noda to replace embattled Prime Minister Naoto Kan as premier, making Noda the party's fifth new leader in six years. The DPJ, however, still faces opposition from the Liberal Democratic Party (LDP) in the upper house of parliament, the Diet, which is hampering its ability to make progress with its policy agenda.

A third supplementary budget, worth ¥12.1 trillion ($155.1bn) and the second-largest ever, was approved by the government in

October. Over 95% of the package will go towards reconstruction efforts in areas affected by the natural disasters in March and will be funded by temporary increases in corporate and income taxes, due to start in early 2013, and the sale of the government's entire majority stake in Japan Tobacco. The new package will be subject to a parliamentary vote in November though the Diet is expected to approve the budget.

In October, the Bank of Japan (BOJ), for the first time since August, unilaterally intervened in currency markets to weaken the yen from post-World War II highs against the US dollar, selling around ¥3 trillion ($38.4bn). Finance Minister Jun Azumi has threatened further action when necessary, but the effect of the latest intervention will again be short-lived. While the yen is strong in absolute terms, in inflation-adjusted terms, it remains nearly 30% below the highs it reached against the dollar in 1995. Further, overseas money managers are set to purchase record amounts of Japanese government bonds this year, having bought ¥14.8 trillion ($189.7bn) of short-term debt in the first nine months of the year. With the JGB yield differential versus US Treasuries narrowing, the yen will remain well supported.

The Ministry of Finance is becoming increasingly concerned about this, especially in light of recent action by the Swiss National Bank to weaken the Swiss franc, effectively eliminating the franc as a safe-haven and diverting flows into the yen. Japan's monetary authorities also worry that the yen has been strengthening against the country's export competitors, especially against the Taiwanese dollar and Korean won, which has weakened by around 40% against the yen since August 2008. Japan's big auto manufacturers have taken advantage of this trend by sourcing car parts from South Korea to cut costs.

Another benefit of the strong yen is that it has boosted acquisitions of foreign companies by Japanese corporates, with overseas mergers and acquisitions amounting to ¥3 trillion ($38.5bn) in the six months to September, up 120% from the same period in 2010. Following March's natural disaster, Japanese companies have been actively seeking to set up alternative offshore production bases. Taiwan has benefited from this trend, with the two countries signing a trade and investment agreement in September, and inbound investment from Japan nearly quadrupling to $100mn in August, up from $27mn June. Economic ties are expected to grow in the future.

While exporters will face challenging conditions, given a euro-zone slowdown, Japanese investors also have substantial exposure to the region. Around 30% of the ¥217.3 trillion ($2.8 trillion) of foreign bonds held in Japan are from euro area member states. The European crisis could prompt a repatriation of investments from the euro area, which would put unwanted upward pressure on the yen. Japanese households have already begun to withdraw from foreign asset markets, especially previously popular emerging markets such as Brazil, a favoured destination for the so-called 'carry trade'. These flows are expected to be reinvested domestically and will underpin Japanese equity and fixed-income markets.

Euro-denominated bonds held by Japanese investors (¥bn)

	Investment Trusts (end- August 2011)	All Japanese Investors (end-2010)
Germany	466	14,853
France	334	10,459
Italy	502	5,715
Belgium	321	1,288
Netherlands	144	6,620
Spain	146	1,992

Source: J P Morgan, October 2011

Japan's economy has rebounded strongly following the natural catastrophe and nuclear disaster, but momentum now appears to be slowing, with retail sales registering two sharp consecutive month-on-month declines of 1.7% and 1.5%, seasonally adjusted, in August and September, respectively. Nevertheless, relative to developed peers, Japan's growth prospects remain favourable, especially given potential for increased reconstruction activity over the next six to 12 months and additional stimulus from the third supplementary budget acting as a counterbalance to weaker external demand.

Euro-Zone: G7 Economies

Germany, France and Italy: EU Leaders Reach Deal to Leverage EFSF

Germany's economy has begun to show signs of a significant downshift in growth. Output grew by just 0.1% quarter on quarter, seasonally adjusted, in the second quarter, from a downwardly revised 1.3% in the first quarter, and 2.8% year on year. Industrial production has shown signs of peaking, falling 1% month on month in August and the manufacturing PMI fell below 50, to 49.1, in October, indicating a contraction for the first time since September 2009, while, in the same month, factory orders fell 4.3% month on month, seasonally adjusted, the sharpest fall since January 2009. Confirming the slowdown, the Ifo Institute's business climate index declined for the fourth consecutive month in October, falling to 106.4, from 107.4 in September, with business confidence steadily declining since February. In response, Germany's Economy Ministry nearly halved its 2011 GDP growth estimate to 1%, from a previous estimate of 1.8%.

Similarly, the French economy stagnated in the second quarter, with growth falling from 0.2% in the first quarter, and grew by 0.7% year on year, while the manufacturing PMI has indicated a decline for three successive months and the services PMI fell sharply in October, to 46, from 51.5 in September. The business sentiment survey, carried out by the National Institute for Statistics and Economic Studies (INSEE), showed confidence fell to levels not seen since July 2010. Meanwhile, the Italian economy shows little growth potential and is expected to grow by a mere 0.5% this year. In October, Italy's manufacturing PMI fell to 43.3, the lowest level since June 2009, sharply down from 48.3 the previous month. The slowdown in the core European economies does not augur well for the euro-zone outlook, with the region, as a whole, expected to enter recession within six months.

Inflation remains elevated, with euro-zone consumer prices 3% higher year on year in September and October, up from 2.5% in August and a full percentage point above the European Central Bank's (ECB) inflation target of 'close to, but below, 2%'. Expected slower growth in the region, however, has encouraged the ECB to take a more constructive view on inflation, which is forecast to fall below 2% next year.

With most of the conditions in place for monetary easing, the ECB, at its November interest-rate setting meeting, unanimously decided to cut the refinancing rate by 25 basis points to 1.25%. This was the first meeting for Mario Draghi, who replaced Jean-Claude Trichet as ECB president on November 1. While further loosening is expected, Draghi is a conservative central banker in the mould of Trichet, suggesting policy continuity. Draghi is unlikely to expand the central bank's bond purchasing programme aggressively to support government bond markets, which would help shore up market confidence, unless market conditions deteriorate significantly.

Italian Prime Minister Silvio Berlusconi had come under increasing pressure in recent months as tensions within the ruling coalition grew. Berlusconi became the most high-profile casualty of the euro-zone debt crisis to date when, in November, he stepped down to be replaced by Mario Monti, a former EU Competition Commissioner, paving the way for a new government to be formed.

Retail Sales, Producer Prices and Wages in the G7 Economies

	Retail Sales (volume) Latest (%)	Producer Prices, Latest (%)	Producer Prices, Year Ago (%)	Wages/ earnings Latest (%)	Wages/ earnings Year Ago (%)
United States	2.5 (Aug)	6.9 (Sep)	3.9	2.0 (Sep)	2.2
Canada	1.8 (Jul)	5.2 (Aug)	0.6	0.6 (Jul)	10.3
Japan	1.1 (Jun)	2.6 (Sep)	-0.2	-0.7 (Aug)	3.9
Euro area	-1.0 (Aug)	5.9 (Aug)	3.6	3.5 (Q2)	1.4
-Germany	-0.9 (Aug)	5.7 (Sep)	7.6	1.6 (Jul)	0.0
-France	0.4 (Aug)	6.3 (Aug)	3.5	2.1 (Q2)	2.0
-Italy	-0.9 (Jul)	4.5 (Aug)	3.5	1.7 (Aug)	2.2
United Kingdom	0.2 (Aug)	6.3 (Sep)	3.8	2.8 (Aug)*	1.7

**June to August.*

Source: The Economist, October 2011

With the debt crisis moving from the smaller peripheral nations into the larger core states, the European Financial Stability Facility (EFSF), at €440bn ($616bn), was deemed to be too small to ringfence the core from contagion. Following a crisis meeting of European Union (EU) officials in October, the 14th meeting within 21 months, it was agreed to leverage the EFSF, raising its capacity to approximately €1 trillion ($1.4 trillion). It was also decided that, having agreed a 21% writedown on Greek government debt in July and realising that this would be insufficient, private investors will face a "voluntary" 50% writedown.

While core euro-zone banks may have sufficient capital to withstand these losses, the risk is that smaller economies such as Portugal and Ireland will want similar debt relief, leading to further substantial writedowns for banks. Combined with the dire state of wholesale funding markets, this has added urgency for action to recapitalise euro-zone banks. Some estimates suggest the banks face the task of raising fresh capital of up to €200bn ($275bn) to €300bn ($412.5bn), to give them a sufficiently large buffer.

Meanwhile, prospects of a fiscal union in the single currency area appear as remote as ever, with Germany's Constitutional Court, despite approving an expansion of the EFSF's remit, adamant that ceding power to a higher authority is not a viable option since it is tantamount to a loss of sovereignty. Since any plan requires the agreement of all 17 euro-zone member states, talks are more likely to produce stop-gap compromise solutions, rather than yielding a permanent solution to resolve the crisis.

Euro-Zone: Non-G7 Economies

Belgium: Constitutional Change a Watershed Moment

Belgian leaders, in October, proposed constitutional amendments to devolve power to regional authorities. Among the proposals is a requirement that a quarter of tax revenues from the federal government will be given to the three regional governments: Brussels, Flanders and Wallonia. These regions will also set their own employment policies, helping address problems of youth unemployment in Wallonia and the Flanders region's difficulty in keeping people in the workforce for longer. Flanders will also gain administrative control over most of Brussels' suburbs and there will be synchronised elections for all levels of government. This proposal marks a key turning point, given that talks between the three regions have been ongoing since inconclusive parliamentary elections were held in June 2010, and appears to be acceptable to all parties, with the Flemish gaining the increased autonomy they have long craved, paving the way for the formation of a ruling coalition.

Following the emergence of severe funding problems for Franco-Belgian lender Dexia, Brussels, in October, agreed to provide €58.5bn ($80.5bn) of state guarantees for the bank, which was nationalised in the process, with state guarantees also provided on the remaining €31.5bn ($43.4bn) of unsold assets. The amount is equivalent to about 15% of Belgium's GDP and will push the government debt to GDP ratio, which was around 96% prior to nationalisation, above 100%. In response, Moody's put the country's long-term foreign currency debt rating, Aa1, on 'negative outlook', joining Fitch and S&P, which changed their outlook to 'negative' on the AA+ ratings in September, due to concerns over the government's ability to tackle its budget deficit.

Other Europe

Switzerland: SNB Pegs Franc to Euro as Deflation Risks Rise

In September, having unsuccessfully attempted to weaken the Swiss franc (SFr) by repurchasing Treasury bills and moving the money into bank deposits the month before, the Swiss National Bank (SNB) set a minimum exchange rate of SFr1.2 per euro. This followed a prolonged period of currency appreciation that has hampered the country's exporters, despite successful attempts by companies to raise productivity, with the franc appreciating by around 43% against the euro from the start of 2010 through to mid-August 2011. In August, exports, in inflation-adjusted terms, fell 7% compared to the previous month, the largest decline since December 2008.

Several Swiss multinational corporations have issued profit warnings and have considered relocating operations outside Switzerland. Potentially, this could have a detrimental impact on investment, which was the main growth driver last year. A quarterly survey carried out by the SNB in July/August showed that the construction sector planned to increase capital spending, while the manufacturing and services sectors expected spending to stay at current levels, whereas the previous survey showed all three sectors planning to increase investment.

A strong Swiss franc also increased the risk of deflation, with consumer prices up by a mere 0.2% over a year ago, in August. The SNB is forecasting deflation of 0.3% next year and recent surveys have also shown that inflation expectations are falling. In response, the central bank stated that it would purchase foreign currency in "unlimited quantities". Pressure from the business community persists, however, with the Labour Directorate at the State Secretariat for Economic Affairs (SECO) stating that the franc remains overvalued and there have been reports that the peg could be moved up further to SFr1.25 per euro.

Switzerland's labour market is also expected to struggle, with SECO forecasting the unemployment rate to rise to 3.1% at year-end, compared to 2.8% in September. In August, the government announced a SFr870mn (US$971.8mn) stimulus package, most of which will go towards unemployment insurance, enabling companies to reduce working hours rather than shed jobs, and tourism. This is the first tranche of a possible SFr2bn (US$2.2bn) in government aid, with a survey by the Swiss Economic Institute (KOF), in September, showing the leading indicator falling to its lowest level in two years, suggesting economic data will soften in the fourth quarter. Economic growth is estimated by BAK Basel, an economic research institute, to fall to 0.8% next year, down from a forecast 2011 expansion of 1.9%, as exports are expected to virtually stagnate.

Scandinavia: Danes Elect Social Democrats, Banking Sector Under Pressure

At their monetary policy meetings, in October, Norway's Norges Bank and Sweden's Riksbank kept their key policy rates unchanged at 2.25% and 2%, respectively. While both central banks tightened policy earlier in the year, the increased likelihood of a global slowdown and uncertainty over resolution of the euro-zone sovereign debt crisis prompted the monetary authorities to adopt a less hawkish stance. The slowdown underway in Sweden is apparent from the manufacturing PMI falling below the 50 level that separates expansion from contraction, with the seasonally-adjusted figure declining to 48.1 in September, down from 60.2 at end-2010. On a month-on-month basis, Swedish retail sales contracted for three consecutive months, seasonally-adjusted, from July through September. Although the Norwegian economy has shown signs of slowing, with the manufacturing PMI falling to 50.8 in October, from a recent peak of 58.5 in February, the country should be better insulated from the euro-zone recession than Sweden, given its high oil receipts.

In October, S&P affirmed Sweden's AAA rating, with a 'stable outlook', highlighting the healthy state of public finances. S&P forecasts an average general government surplus of 1.5% of GDP from 2012 through 2014, with the economy's flexibility and strong fiscal position expected to provide a buffer against external shocks. High household debt, estimated at 140% of GDP, is a concern, but high levels of non-housing assets, low interest rates and strong wage gains in recent years, provide a cushion.

Denmark's centre-left Social Democrats won parliamentary elections in September, ending a 10-year absence from power, and, in the process, Helle Thorning-Schmidt became the country's first female prime minister. It was a narrow victory, with the centre-left coalition winning 92 seats, compared to 87 for the centre-right. Although the Social Democrats will lead the coalition, the party fared worse than in the last election in 2007, winning 44 seats in the 179-seat parliament, while the outgoing centre-right Liberal party took 47 seats and remains the largest party in parliament.

Thorning-Schmidt aims to boost government spending on health and education, financed by increased taxes on the financial sector and high earners. She also wants to implement 'Glass-Steagall'-style legislation, whereby banks' retail and investment banking arms are separated. Tensions within the ruling coalition are likely, however, given the differences between the Social Democrats, the far-left Red-Green Alliance and the centrist Liberal Party, making it difficult for her government to implement its agenda.

While Denmark's public-sector debt to GDP ratio of 47% is relatively low, there are concerns regarding high household debt, with negative equity affecting around 20% of households, and a high private-sector credit to GDP ratio of 228.9%. Under Danish law, when the loan-to-value ratio on a mortgage exceeds 80%, the lender must inject more collateral, highlighting the fragility of the banking sector, where the state has taken over nine bankrupt banks since 2008. Several small regional banks have been allowed to fail, but there are concerns about the country's budgetary position, which is expected to move to a deficit of 4.6% of GDP this year and widen further in 2012. Second-quarter GDP grew by 1% quarter on quarter, seasonally adjusted, from growth of just 0.1% in the first quarter, and by a seasonally-unadjusted 1.8% over a year earlier, driven by a recovery in fixed investment and transport equipment production. This rate of expansion, however, is not expected to continue, with the Danish economy projected to slow in the second half and full-year 2011 growth of 1% to 1.5% forecast.

Australia and New Zealand: RBA Cuts Rates on Global Growth Fears

At its November monetary policy meeting, the Reserve Bank of Australia (RBA) cut the cash target rate by 25 basis points to 4.5%. The central bank remains concerned about the economic impact of financial market volatility in Europe and the US on the Australian economy. Recent data indicate the domestic economy is now slowing, while the RBA also has a more constructive view on inflation. Consumer prices rose 3.5% over a year ago in the third quarter, down from 3.6% the second quarter, but the monetary authorities believe that conditions are in place for inflation to fall to within their target range of 2% to 3% next year.

Softer labour-market data are expected to lead to less upward pressure on wages, with the unemployment rate rising to 5.3% in August, the highest level since October 2010, before falling marginally to 5.2% in September. The increasing influence of trade unions, due to changes in regulation, has the potential to disrupt the economy as the frequency of strikes is likely to increase and reduced labour-market flexibility could leave firms reluctant to hire, given the uncertain environment.

Meanwhile, the housing market has shown a weakening trend this year. House prices have continued to fall, declining by 3% in the year to August, while building approvals fell by 8% in the first eight months of this year, compared to the same period in 2010. The majority of mortgages are variable rate and track the RBA's key policy rate, further justifying the case for a looser monetary policy stance.

While some sectors and regions are expected to slow, the mining sector and related regions are set to continue expanding. The value of mining projects in the pipeline has risen to A$830bn (US$862.8bn) at present, up A$106bn (US$110.2bn) over a year earlier. Economic growth in 2012 will also be boosted by energy projects, with the confirmed A$29bn (US$30bn) Wheatstone liquefied natural gas project in Western Australia bringing next year's investment spending on such projects to more than A$120bn (US$124.7bn). The uplift to 2012 GDP growth from these investments is estimated to be 2%, providing a counterbalance to a softening of output elsewhere in the economy, though economic activity is expected to grow robustly, in the range of 3.5% to 4.5%, next year.

Australian Retail Sales (% change over a year ago)

State	Change in Retail Sales, Latest
New South Wales	0.8
Victoria	1.7
Queensland	3.4
Western Australia	8.0

Source: Bank of America Merrill Lynch, November 2011

New Zealand has benefited from the Reserve Bank of New Zealand's (RBNZ) loosening of monetary policy in March, with data suggesting that the economy is returning to health following the devastating earthquakes in Christchurch over the past 12 months. Agriculture has fared well due to favourable weather conditions, leading to high levels of production and strong revenues for exporters as soft commodity prices have remained firm. In the second half, the country will also benefit from the boost from having hosted the 2011 Rugby World Cup in September/October. Reconstruction spending in the Canterbury region has been delayed, however, due to continuing aftershocks, which has hindered planning. If the aftershocks dissipate, reconstruction activity would provide a fillip to the economy in 2012.

While inflation is well above the central bank's target range of 1% to 3%, much of this is due to tax rises, which will drop out of the year-on-year comparisons in 2012, and this is expected to bring inflation back to within target. The RBNZ forecasts consumer prices, in the year to March 2012, to rise 2.1% year on year, down from 4.5% for the same period a year earlier. In the third quarter, consumer prices rose 4.6% over a year ago, down from 5.3% in the second quarter. Moderating inflation gives the RBNZ leeway to leave the overnight cash rate, which was left unchanged in October, at 2.5%.

In September, both Fitch and S&P downgraded New Zealand's long-term foreign currency rating to AA, with a 'stable outlook', from AA+. The downgrades reflect the country's high level of net external debt, which stood at 83% of GDP, in US dollar terms, at end-2010. High household debt, equal to around 150% of disposable income, and rising government debt, due to costs associated with the Christchurch earthquakes, also weighed on the sovereign debt rating. ◆

Michael E. Russell & Lyndon Barreto, November 2011

KEY ECONOMIC AND FINANCIAL INDICATORS *(All data shown are as at end-October 2011 unless otherwise stated)*

	Developed Market	Annual GDP Growth YoY (% change on year ago)	Quarterly GDP Growth QoQ* (% change on year ago)	Industrial Production Growth YoY (% change on year ago)	Inflation CPI YoY	Trade Balance (Latest 12 months)	Current Account (Latest 12 months)	Foreign Reserves 2011 Latest	Foreign Reserves 2010 Year Ago	Currency vs $ 2011 Latest	Currency vs $ 2010 Year ago	Sovereign Rating S&P	Budget Balance % of GDP 2011F**	3-Month Interest Rates	2012 PER Forecast	% MSCI ACWI Net***	Stock Market Index (MSCI ACWI Net) US$	Change since 12/31/10 US$	Change since 12/31/10 Local	3 month Currency vs $ +/- (Forecast)
		%	%	%	%	$ Bns	$ Bns	$ Bns	$ Bns					%		Oct. 31, 2011	Oct. 31, 2011	%	%	
Over Weight	CANADA	2.2	-0.4	1.5	3.2	-5.3	-53.4	64.5	57.9	1.01	1.00	AAA	-3.8	0.87	11.8	4.56	4538.35	-8.23	-8.26	+
	SINGAPORE	5.9	1.3	12.8	5.5	46.2	51.3	249.2	206.4	1.28	1.30	AAA	0.3	0.42	11.9	0.66	865.74	-8.31	-10.38	+
	SWITZERLAND	2.3	1.4	2.3	0.5	24.1	86.1	385.4	249.6	0.88	1.00	AAA	0.8	0.04	11.0	3.21	6986.08	-2.93	-9.31	+
	SWEDEN	4.9	3.6	5.6	3.2	13.4	35.0	53.8	52.9	6.58	6.80	AAA	0.6	2.51	10.8	1.15	15151.29	-10.53	-13.95	-
	HONG KONG	5.1	-2.0	2.0	5.8	-49.3	14.3	279.6	261.4	7.77	7.80	AAA	1.8	0.28	13.5	1.05	34308.08	-11.08	-11.18	uc
	JAPAN	-1.1	-2.1	0.4	0.2	20.6	153.3	1218.5	1109.6	76.00	81.70	AA-	-8.3	0.15	10.8	7.98	3695.02	-11.11	-14.54	+
	UK	0.6	0.4	-1.0	5.2	-158.3	-40.9	125.8	102.4	0.63	0.60	AAA	-8.8	1.00	9.1	8.55	4566.54	0.08	-2.92	-
	GERMANY	2.8	0.5	7.9	2.6	197.8	192.3	266.9	205.8	0.72	0.70	AAA	-1.7	1.59	8.9	3.11	3646.87	-8.50	-11.99	-
	UNITED STATES	1.6	1.3	3.2	3.9	-711.1	-469.9	146.3	132.4	-	-	AA+	-9.1	0.13	11.6	44.45	3009.53	0.83	0.83	n.a.
Neutral	NORWAY	-0.4	1.5	6.1	1.6	68.2	54.1	51.7	49.1	5.54	5.90	AAA	13.1	3.10	9.0	0.36	7369.07	-3.32	-8.27	-
	NEW ZEALAND	0.7	0.3	0.8	4.6	0.9	-5.6	20.5	16.2	1.26	1.40	AA	-8.4	2.77	11.5	0.05	271.92	9.80	5.63	-
	DENMARK	1.8	4.1	4.7	2.5	13.8	21.5	93.2	80.1	5.39	5.40	AAA	-3.9	1.42	12.1	0.37	10694.19	-16.65	-19.95	-
	NETHERLANDS	1.6	1.0	1.5	2.7	59.7	66.0	57.2	44.9	0.72	0.70	AAA	-3.8	1.59	8.6	0.95	7645.17	-6.78	-10.34	-
	IRELAND	2.3	6.4	11.5	2.6	60.2	1.5	2.2	2.2	0.72	0.70	BBB+	-10.1	1.59	15.8	0.10	187.21	4.81	0.81	-
Under Weight	AUSTRALIA	1.4	4.8	-3.3	3.5	30.1	-33.5	46.8	37.5	0.97	1.00	AAA	-2.6	4.81	10.2	3.42	2868.81	-3.04	-6.32	-
	FRANCE	1.7	0.0	4.4	2.2	-93.1	-63.5	199.8	148.5	0.72	0.70	AAA	-5.8	1.59	8.4	3.55	3774.83	-8.61	-12.10	-
	FINLAND	2.9	2.5	2.3	3.7	3.0	2.5	11.2	9.9	0.72	0.70	AAA	-1.7	1.54	12.2	0.35	589.53	-20.63	-23.66	-
	ISRAEL	3.5	3.5	2.6	2.9	-14.5	2.5	78.0	66.5	3.66	3.60	A+	-2.4	2.88	8.2	0.25	131.10	-22.22	-20.66	-
	ITALY	0.8	1.2	4.7	3.1	-49.3	-81.9	192.3	144.8	0.72	0.70	A	-3.7	1.59	7.8	0.92	643.68	-13.41	-16.71	-
	BELGIUM	2.3	2.1	4.0	3.6	13.1	2.4	31.4	25.7	0.72	0.70	AA+	-3.8	1.59	10.0	0.35	5048.86	-7.81	-11.33	-
	AUSTRIA	3.5	2.7	5.6	3.8	-8.7	11.2	28.0	21.1	0.72	0.70	AAA	-3.6	1.59	7.9	0.10	2480.73	-28.60	-31.33	-
	SPAIN	0.7	0.6	0.6	3.1	-65.0	-62.1	39.0	30.1	0.72	0.70	AA-	-6.5	1.59	8.9	1.31	2811.29	-2.42	-6.15	-
	PORTUGAL	-0.9	-0.1	-0.5	3.6	-25.2	-20.2	25.2	20.1	0.72	0.70	BBB-	-6.7	1.59	10.4	0.09	192.45	-11.77	-15.14	-
	GREECE	-7.3	n.a.	-11.7	3.1	-37.8	-30.1	6.8	6.0	0.72	0.70	CC	-9.1	1.59	4.6	0.05	229.31	-50.65	-52.66	-

Column groups: Macroeconomic Data (Annual GDP Growth through 2012 PER Forecast); Market Performance (% MSCI ACWI Net through Change since 12/31/10 Local); Forecast (3 month Currency vs $).

*Note: S&P credit rating shown is long-term foreign currency rating. * % change in GDP on previous quarter, annual rate. ** Economist Intelligence Unit forecast. ***MSCI All Country World Daily Total Return Index Net. Global emerging markets had a 13.08% weighting in the MSCI ACWI Index as at 31 October 2011. The CLIG recommended weighting for global emerging markets for the fourth quarter 2011 is 15%; the recommended weighting for developed markets is 85%.*

Source: City of London Investment Management, Bank for International Settlements, central banks, International Monetary Fund, Standard & Poor's, The Economist, J P Morgan.

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