

Our main differences from consensus

- **2011: Weaker for Asia (0.5pp)**
- **2012: Weaker for the US (0.5pp), Asia (1.4) and Latin America (0.6), stronger for Europe's core**
- **A substantially weaker outlook for the primary exporting economies in particular**

Economic summary

- The downward shift in the consensus outlook over the months is a belated acceptance of the atypical nature of this recovery
- Growth in developed economies stands to be muted for years yet, with the impact being felt globally
- The US has seen some straws of recovery, but animal spirits are yet to return, and necessary fiscal consolidation is yet to start
- In Europe, progress by crisis continues: investors are waiting for policymakers to put economies on a path to fiscal sustainability
- The primary exporting economies are being affected by the slowdown in world demand
- **Risks:** Further financial and real instability in late 2011 or 2012, and a sharper than expected slowdown in Asia and the BRICs

Market summary (provided by Amphora Capital)

- **Policy rates and bond yields:** Bond markets now reflect expectations of a major slowdown of the global economy, and associated high risk premia. Yields are thereby unlikely to decline significantly further.
- **FX:** Additional dollar weakness is likely, vis-à-vis most currencies. **Sterling and gilts:** Tighter UK fiscal policy supports both.
- **Equities:** Global equity market valuations have adjusted downwards, but profit expectations appear consistent with a more optimistic outturn than we expect to materialise, implying more downside as the global slowdown unfolds.
- **Commodities:** Recent weakness in global commodity prices is consistent with a slowing global economy. The relative outperformance of precious metals is warranted, however, given sovereign debt sustainability concerns.
- **Risks:** Worsening sovereign debt dynamics, a cyclical global downturn, and trade and currency disputes could continue to weigh on asset valuations.

Region	Weight in world GDP	Real GDP growth (%y-o-y)					Difference from consensus (percentage points)	
		Actual		Forecast			2011	2012
		2010	Average 1989-07	2009	2010	2011		
Europe	29	-	-4.1	2.0	1.9	0.8	0.0	0.2
Euro area	19	2.2	-4.0	1.7	1.5	0.5	0.0	0.0
Germany	5	1.9	-5.0	3.6	2.9	1.1	0.0	0.3
France	4	2.0	-2.2	1.5	1.6	0.9	0.0	0.2
UK	4	2.4	-4.9	1.3	1.0	1.0	0.0	-0.1
Italy	3	1.4	-5.0	1.1	0.6	-0.5	0.0	-0.3
Periphery*	3	3.4	-3.7	-0.6	-0.5	-0.7	0.0	-0.2
North America	26	-	-2.5	2.8	1.8	1.6	0.0	-0.5
US	23	2.9	-2.4	2.8	1.8	1.6	0.0	-0.5
Canada	3	2.6	-2.6	3.1	2.3	1.7	0.0	-0.3
Asia	27	-	1.5	7.2	4.3	4.1	-0.5	-1.4
Japan	9	1.6	-5.2	3.9	-0.4	2.1	0.0	0.0
China	9	10.0	8.7	10.3	8.1	6.0	-1.0	-2.5
India	2	6.3	5.7	8.6	7.1	5.8	-0.3	-1.9
Latin America	8	-	-2.0	6.0	4.1	3.0	0.0	-0.6
Brazil	3	2.5	-0.2	7.5	3.2	3.0	0.0	-0.5
Other	11	-	-2.0	3.8	3.8	3.8	-0.1	-0.5
Global	100	-	-1.9	4.0	2.9	2.4	-0.1	-0.6

* a (weighted) average of Greece, Ireland, Portugal and Spain
Regional weights may not sum to 100 due to rounding.
The cut off date for information is 29 November 2011.

FX rate	Policy rate	10y yield	Equities*
Mid 2012			
1.45	1.25%	2.2%	U
1.65	1.0%	2.6%	U
N/A	0.25%	2.4%	U
1.00	1.25%	2.5%	U
72	0.1%	1.0%	N
6.4	3.5%	N/A	U
48	6.0%	N/A	U
1.75	9.5%	N/A	N

* O = overweight, U = underweight, N = neutral

Consensus, although now anticipating a slow and grudging Western recovery, continues its reluctance to factor in a material slowdown in Asia and the primary exporting economies.

The US

Recent data, including on homebuilding, investment, spending on motor vehicles, exports, and Q3 GDP growth have been positive. GDP is now back to pre-crisis levels; policy has been effective. Consensus rose this month, marginally.

Confidence is still low however, and the fundamentals remain weak. Employment and private residential fixed investment are historically low, and deficits, gross government debt, and on- and off-balance-sheet liabilities held by third parties, worryingly high. Household deleveraging has miles to go.

Although corporations do not look overleveraged, and there is much liquidity available to invest (over \$1trn), the myriad uncertainties, risks, and prospects of longer lasting slow growth continue to amplify investment caution, and keep animal spirits subdued. Further significant fiscal stimulus seems unlikely until at least the second half of the new presidency.

Necessary fiscal consolidation is still to come, but is unlikely before the latter half of 2012 at the earliest. Meanwhile the downside risks from not implementing credible debt and deficit reduction policy continue to grow, and arguably are coming closer to the extent that the European crisis proceeds step-wise to resolution. Markets have a tendency to focus on one thing at a time.

We are inclined to regard the recent GDP bounce as 'noise', and maintain a forecast of 1.6% growth for 2012.

Europe

The Consensus forecast for euro area GDP growth in 2012 is now 0.4pp, a whole percentage point below what it was in August.

Europe's problems continue. To put them right however does not mean that they all have to be solved now. Now that Mrs Merkel is engaged, the question is whether she is able to lead Europe to a solid future. Our judgement is that she will, and that the French, and thence other European leaders, will agree to a more fiscally conservative, more German, Europe, with enforcement written into a revised, or new, treaty.

The will to save Europe seems stronger in Germany than the English-language papers imply: it is not in Germany's interest for the euro to fail. But neither does Germany intend to pay for it all, and sign a blank cheque. Serious issues do get debated properly in Germany, and ultimately we believe the 'right' decision will be made.

We judge that, provided the requisite reforms are made, G20 'big guns' stand to be brought to bear if needed, in a demonstration of international resolve and commitment to take all necessary measures to restore confidence.

The ECB meanwhile is buying just enough Italian et al paper to stop rates from blowing out, while still keeping the pressure on the politicians/people to agree to fiscal, structural reforms, and treaty changes.

The 'new Europe', if it does eventuate as we expect, is likely to be stronger as a result of its crises. The UK, however risks becoming somewhat more peripheral.

Taking everything together, our view is that the consensus GDP forecast for core Europe has now come down a bit far: we judge that domestic demand next year will be less weak than current expectations.

Asia

The high growth rates of the past decade stand to be difficult to maintain in the face of a sluggish West. If the 20%-odd y-o-y growth in investment were to slow, consequences for GDP would be significant. A slowdown in investment will come, the only question is when.

China does not have a labour constraint, and so has a high potential growth rate, and has ample fiscal space that could be used to support domestic demand. But nevertheless policymakers have to keep fiscal policy on a sustainable path; longer term, consumption would have to take over the running.

The restructurings and economic diversification required to re-balance economies towards greater reliance on domestic demand take time. Historically, few countries have managed this well, certainly Japan did not. We remain considerably below Consensus GDP growth.

Primary exporters

There is now concrete evidence of a mounting slowdown in the primary exporting economies. PMI data are weak, and OECD composite leading indicators continue down. All this points to a deeper slowdown than currently envisaged by Consensus. This stands to affect Latin America in particular.

Bond markets now reflect expectations of a major slowdown of the global economy and associated high risk premia. Yields are thereby unlikely to decline significantly further.

Global bond yields remain low due to expectations of a major global economic slowdown over the coming year. However, with inflation trending higher in many countries, and sovereign debt burdens rising rapidly, yields are unlikely to decline much from here, even as the global slowdown unfolds in the coming quarters.

The US Fed's decision to extend the average maturity of its Treasury holdings has had little impact, most probably because this action was well anticipated.

At the margin, the rebuilding effort in Japan is likely to place some upward pressure on global bond yields as Japan's net savings position declines.

Additional dollar weakness is likely, vis-à-vis most currencies.

Recent dollar strength reflects a global rush into liquidity, associated with sharp declines in risk assets generally. This is comparable in key respects to what occurred in late 2008.

In our view, the dollar's bounce is likely to be temporary. As the US continues to face a major deterioration in its fiscal position, and remains heavily reliant on foreign financing, the dollar is likely to come under further downward pressure vis-à-vis most currencies in late 2011, and in 2012.

However, as seen this month, Japan, China and other Asian economies will continue to intervene as required to slow their currencies' appreciation, although we do not believe that they will reverse the trend.

Tighter UK fiscal policy supports sterling and gilts.

Assuming, as we do, that UK fiscal consolidation continues apace into 2012, this would be supportive of sterling and gilts. However, any indications that the coalition government was struggling with its cost-cutting programme would be potentially negative.

Financial markets have now priced out further rate hikes in the UK, which has lent some support to gilts. The potential for a further decline in gilt yields is accordingly limited, without a dramatic decline in inflation.

Global equity market valuations have adjusted downwards, but profit expectations appear consistent with a more optimistic outturn than we expect to materialise, implying more downside as the global slowdown unfolds.

While equity markets have naturally adjusted to reflect increasing expectations of a major global economic slowdown, we are surprised by the optimism implicit in corporate profit expectations for 2012. Should earnings disappoint, this would expose more potential downside for equity markets.

Cyclical and financial shares have suffered in particular of late, which is consistent with recent developments. However, much of the relative adjustment has probably now taken place, leaving these sectors more fairly valued relative to others.

Recent weakness in global commodity prices is consistent with a slowing global economy. The relative outperformance of precious metals is warranted, however, given sovereign debt sustainability concerns.

We believe that the recent bounce in industrial commodities is unsustainable amidst an unfolding global economic slowdown. The outlook for precious metals is somewhat better, assuming that the dollar remains in a downtrend in the medium-term.

Indications that governments are taking credible action to get deficits under control would most probably lead to a sharp pullback in precious metals prices, as safe-haven buying is the major source of demand at present.

Worsening sovereign debt dynamics, a cyclical global downturn, and trade and currency disputes could continue to weigh on asset valuations generally.

Recent developments reinforce our concern that a potential 'perfect storm' of negative factors, the combination of which has yet to be priced into financial markets, could materialise by 2012.

Unlike in 2008, when fiscal and monetary policies were both able to address the immediate issues, this is not going to be the case over the coming year.

Recent rhetoric between the US and China is particularly worrying. The last thing the global economy needs now is a major trade war, which would have severe negative consequences for confidence and growth.■

AMPHORA CAPITAL LLP

Protecting Wealth | Ensuring Liquidity

Our main differences from consensus

- **2011: Weaker for China and Asia (1.0pp and 0.5pp respectively)**
- **2012: Weaker for the US (0.3pp), Europe's periphery (0.2pp) and more so for Asia and Latin America**
- **A substantially weaker outlook for the primary exporting economies in particular**

Economic summary

- The downward shift in the consensus outlook across the developed world reflects the atypical nature of this recovery
- Growth in developed economies stands to be muted for years, with the impact being felt globally
- The US has seen some straws of recovery, but animal spirits are yet to return, and necessary fiscal consolidation is yet to come
- In Europe, progress by crisis continues: markets are however perhaps starting to see a path to sustainability
- The primary exporting economies are being affected by the slowdown in world demand
- **Risks:** Further financial and real instability in late 2011 or 2012, and a sharper than expected slowdown in Asia and the BRICs

Market summary (provided by Amphora Capital)

- **Policy rates and bond yields:** Bond markets now reflect expectations of a major slowdown of the global economy, and associated high risk premia. Yields are thereby unlikely to decline significantly further.
- **FX:** Additional dollar weakness is likely, vis-à-vis most currencies. **Sterling and gilts:** Tighter UK fiscal policy supports both.
- **Equities:** The recent strong bounce in equity markets takes valuations back to unattractive levels. Profit expectations remain unreasonably high, implying more downside as the global slowdown unfolds.
- **Commodities:** Prices have bounced, in particular for industrial commodities. This is unsustainable in a global slowdown. The relative outperformance of precious metals is warranted, however, given sovereign debt sustainability concerns.
- **Risks:** Worsening sovereign debt dynamics, cyclical global downturn, and trade and currency disputes could continue to weigh on asset valuations.

Region	Weight in world GDP	Real GDP growth (%y-o-y)					Difference from consensus (percentage points)	
		Actual	Forecast			2011	2012	
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Europe	29	-	-4.1	2.0	1.9	1.3	0.0	0.2
Euro area	19	2.2	-4.0	1.7	1.6	0.9	0.0	0.3
Germany	5	1.9	-5.0	3.6	2.9	1.6	0.0	0.6
France	4	2.0	-2.2	1.5	1.6	1.4	0.0	0.5
UK	4	2.4	-4.9	1.3	1.0	1.3	0.0	-0.2
Italy	3	1.4	-5.0	1.1	0.7	0.0	0.0	0.0
Periphery*	3	3.4	-3.7	-0.6	-0.5	-0.5	0.0	-0.2
North America	26	-	-2.5	2.8	1.8	1.6	0.0	-0.3
US	23	2.9	-2.4	2.8	1.7	1.6	0.0	-0.3
Canada	3	2.6	-2.6	3.1	2.3	1.7	0.0	-0.3
Asia	27	-	1.5	7.2	4.3	4.1	-0.5	-1.4
Japan	9	1.6	-5.2	3.9	-0.5	2.1	0.0	-0.1
China	9	10.0	8.7	10.3	8.1	6.0	-1.0	-2.5
India	2	6.3	5.7	8.6	7.2	6.0	-0.3	-1.9
Latin America	8	-	-2.0	6.0	4.2	3.0	0.0	-0.8
Brazil	3	2.5	-0.2	7.5	3.4	3.0	0.0	-0.8
Other	11	-	-2.0	3.8	3.8	3.8	-0.1	-0.5
Global	100	-	-1.9	4.0	2.9	2.5	-0.1	-0.5

* a (weighted) average of Greece, Ireland, Portugal and Spain
Regional weights may not sum to 100 due to rounding.
The cut off date for information is 1 November 2011.

FX rate	Policy rate	10y yield	Equities*
Mid 2012			
1.45	1.25%	2.2%	U
1.65	1.0%	2.6%	U
N/A	0.25%	2.4%	U
1.00	1.25%	2.5%	U
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1.75	9.5%	N/A	N

* O = overweight, U = underweight, N = neutral

Consensus, although now recognising the slow and grudging nature of the Western recovery, has shown an extreme reluctance to factor in a material slowdown in Asia and the primary exporting economies.

The US

Recent data, including on homebuilding, investment, spending on motor vehicles, exports, and Q3 GDP growth have been positive. GDP is now back to pre-crisis levels; policy has been effective.

The fundamentals remain weak, however. Employment and private residential fixed investment are historically low, and deficit, gross government debt, and on- and off-balance-sheet liabilities held by third parties, worryingly high. Household deleveraging has miles to go, and consumer sentiment is particularly low.

Although corporations do not look overleveraged, and there is much liquidity available to invest (over \$1trn), the myriad uncertainties, risks, and prospects of longer lasting slow growth continue to amplify investment caution, and keep animal spirits subdued.

Further significant fiscal stimulus seems unlikely until at least the second half of the new presidency.

Necessary fiscal consolidation is still to come, but is unlikely before the latter half of 2012 at the earliest. Meanwhile the downside risks from not implementing credible debt and deficit reduction policy continue to grow, and arguably come closer as the European crisis continues step-wise to resolution. Markets have a tendency to focus on one thing at a time.

Consensus GDP growth came towards our forecasts again in October for 2012, so that we are now only marginally below Consensus.

Europe

In Europe, we expect progress to continue to be made, step-wise, following the significant advances made in Brussels on 26 October, including the commitments to strengthen the EFSF, recapitalise the banks, and write Greek debt down further.

Budget deficit reduction/restructuring measures continue in the economies of the core, and the periphery.

An important next step for Europe will be to demonstrate that Italy does not have a solvency

problem, only one of liquidity. A fund that is large enough to prove there is no liquidity problem is needed, something that the EFSF is not designed to do, but existing IMF mechanisms are.

Leadership has proved to be stronger than many had expected, resulting in co-ordinated action that at times seemed unlikely. G20 'big guns' are now only just over the horizon, demonstrating a wider resolve and commitment to take all necessary measures in averting catastrophe.

The 'new Europe', if indeed it does eventuate, as we expect, is likely to be stronger as a result of its crises. The UK, meanwhile seems likely to be more peripheral.

The consensus GDP forecast for core Europe has in our view now come down too far: we judge that domestic demand next year will be less weak than current expectations

Asia

The high growth rates of the past decade stand to be difficult to maintain in the face of a sluggish Western performance. The restructurings and economic diversification required to re-focus economies towards a more reliance on domestic demand take time, and require interventionist policies. Historically, few countries have managed such transitions well, even in the best of times.

Efforts to slow the overheating economies, and avoid the potentially destabilising effects of higher prices, continue, putting further downward pressure on growth.

In China, data continue to show weak consumer confidence and insufficiently-strong consumption growth: yet Consensus for 2012 still shows little change. In Japan, Consensus remains unchanged for 2011, and has moderated downwards again for 2012

Primary exporters

There is now concrete evidence of a mounting slowdown in the primary exporting economies. PMI data are weak, OECD composite leading indicators continue down, September saw the biggest falls since 2008 in commodity prices (CRB index), and stock markets have shown considerable weakness.

All this points to a deeper slowdown than currently envisaged by Consensus. This stands to affect Latin America in particular.

Bond markets now reflect expectations of a major slowdown of the global economy and associated high risk premia. Yields are thereby unlikely to decline significantly further.

With inflation trending higher in many countries, however, and sovereign debt burdens rising rapidly, yields are unlikely to decline much further, even as the global slowdown unfolds in the coming quarters.

The US Fed's decision to extend the average maturity of its Treasury holdings has had little impact: the action was well anticipated.

The rebuilding effort in Japan is likely, at the margin, to place some upward pressure on global bond yields as Japan's net savings position declines.

Additional dollar weakness is likely, vis-à-vis most currencies.

Recent dollar strength reflects a global rush into liquidity associated with sharp declines in risk assets generally. This is comparable in key respects with what happened in late 2008.

The dollar's bounce is likely, in our view, to be temporary. With the US continuing to face a major deterioration in its fiscal position, and remaining heavily reliant on foreign financing, the dollar is likely to come under further downward pressure vis-à-vis most currencies in late 2011, and in 2012.

However, as seen this month, Japan, China and other Asian economies are likely to continue to intervene as required to slow their currencies' appreciation, although we do not believe that they will reverse the trend.

Tighter UK fiscal policy supports sterling and gilts.

If, as we assume, that UK fiscal consolidation continues apace into 2012, this will prove supportive of sterling and gilts. However, any indications that the coalition government was struggling with its cost-cutting programme would be potentially negative.

Financial markets have now priced out further rate hikes in the UK, which has lent some support to gilts. The potential for a further decline in gilt yields is accordingly limited, without a dramatic decline in inflation.

The recent, strong bounce in equity markets takes valuations back to unattractive levels. Profit expectations remain unreasonably high, implying more downside as the global slowdown unfolds.

While equity markets have naturally adjusted to reflect increasing expectations of a major global economic slowdown, we are surprised by the optimism implicit in corporate profit expectations for 2012. Should earnings disappoint, this would expose more potential downside for equity markets.

Cyclical and financial shares in particular have suffered, which is consistent with recent developments. However, much of the relative adjustment has probably now taken place, leaving these sectors more fairly valued relative to others.

Commodity prices have also bounced, in particular those for industrial commodities. This is unsustainable in a global slowdown.

The relative outperformance of precious metals seems warranted, however, given sovereign debt sustainability concerns, provided that, as we expect, the dollar remains in a downtrend in the medium-term.

Indications that governments are taking credible action to bring deficits under control would, however, most probably lead to a sharp pullback in precious metals prices, because safe-haven buying is a major source of demand at present.

Worsening sovereign debt dynamics, a cyclical global downturn, and trade and currency disputes could continue to weigh on asset valuations generally.

Recent developments reinforce our concern that a potential 'perfect storm' of negative factors, the combination of which has yet to be priced into financial markets, could materialise by 2012.

Unlike in 2008, when fiscal and monetary policies were both able to address the immediate issues, this is not going to be the case over the coming year.

Recent rhetoric between the US and China is particularly worrying. The last thing the global economy needs now is a major trade war, which would have severe negative consequences for confidence and growth.■

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- **2012: weaker for the US (0.5pp), Europe's periphery (0.6pp) and more so for Asia and Latin America**
- **A substantially weaker outlook for the primary exporting economies in particular**

Economic summary

- The recent marked shift in the consensus outlook at last reflects the atypical nature of this recovery
- In the US animal spirits have yet to return, while the necessary fiscal consolidation is yet to come
- In Europe progress is being made, but only slowly, and risks are huge. Signs of eventual crisis resolution however look promising
- Growth in developed economies stands to be muted for years, with the impact being felt globally
- The primary exporting economies in particular stand to be affected, indeed there is concrete evidence this has already started
- **Risks:** Further financial and real instability in late 2011 or 2012, and a sharper than expected slowdown in Asia and the BRICs

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- **Equities:** The continuing decline in global equity markets has adjusted valuations to more sensible levels. However, profit expectations remain unreasonably high, implying more downside as the global slowdown unfolds.
- **Commodities:** Recent weakness in global commodity prices is consistent with a slowing global economy. The relative outperformance of precious metals is warranted, however, given sovereign debt sustainability concerns.
- **Risks:** Worsening sovereign debt dynamics, a cyclical global downturn, and trade and currency disputes could continue to weigh on asset valuations

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China	9	10.0	8.7	10.3	8.1	6.0	-1.0	-2.6
India	2	6.3	5.7	8.6	7.2	6.0	-0.3	-2.0
Latin America	8	-	-2.0	6.0	4.2	3.0	0.0	-0.9
Brazil	3	2.5	-0.2	7.5	3.6	3.0	-0.1	-0.5
Other	11	-	-2.0	3.8	3.8	3.7	-0.2	-0.7
Global	100	-	-1.9	4.0	2.9	2.5	-0.2	-0.7

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The cut off date for information is 5 October 2011.

FX rate	Policy rate	10y yield	Equities*
Mid 2012			
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1.65	1.0%	2.6%	N
N/A	0.25%	2.4%	N
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72	0.1%	1.0%	O
6.4	3.5%	N/A	U
48	6.0%	N/A	U
1.75	9.5%	N/A	N

* O = overweight, U = underweight, N = neutral

Consensus is no longer reading the nature of the recession incorrectly: it recognises the slow and grudging nature of the Western recovery, a product of synchronous de-leveraging and fiscal tightening.

The impact stands to be felt globally, and by the export-orientated economies in particular.

The US

Negative data from the US, including high rates of long term unemployment, and the resistance to additional stimulus by the Republicans, is seemingly endless.

Although corporations do not look overleveraged, and there is much liquidity available to invest (over \$1trn), the myriad uncertainties and risks at home and abroad are amplifying investment caution, keeping animal spirits subdued.

The historically high levels of gross government debt, combined with on- and off-balance-sheet liabilities held by third parties, give cause for concern. Private sector deleveraging has miles to go.

The (necessary) fiscal consolidation is still to come, but stands not to come into effect until the latter half of 2012 at the earliest. Meanwhile the downside risks from not implementing credible debt and deficit reduction policy continue to grow.

Consensus GDP growth came towards our forecasts again in September, for both 2011 and 2012, but it is hard to see from where the greater-than 2% growth projected for next year could come: we remain below Consensus.

Europe

Although Europe has the tools to deal with its regional crisis, complex structures and problems of the political economy augment it to a gargantuan task. Policy responses have, perhaps not surprisingly, been slow, and often inadequate.

Progress is nonetheless being made. Budget deficit reduction measures are being implemented in the economies of the core and periphery, and are broadly on target. Projected public debt for 2011 for the euro area in aggregate is lower than for the US. The vote at the end of September on the EFSF was won in Germany, identifying a "... strong majority for the rescue of the euro".

That said, the need for strong, decisive leadership and co-ordinated, unified action within the EU has never been stronger. This moment of historic responsibility, is not however confined to the governments of Europe. The ramifications of a disorganised break-up of the euro area, with a potential unravelling of the EU – which accounts for over a quarter of global GDP – would be catastrophic for the world. All governments have a 'duty of care'.

Some signs are promising. The G20, in the communiqué of 22 September made a commitment to bold co-ordinated policy, and leaders pledged "... to take all necessary actions to preserve the stability of banking systems and financial markets as required." Big guns, if needed, are over the horizon.

Consensus is now, we judge, at realistic rates of growth, and such tepid rates stand to feature for some years.

Asia

The high growth rates of the past decade stand to be difficult to maintain in the face of a sluggish Western performance. The restructurings and economic diversification required to re-focus economies towards a more reliance on domestic demand take time, and require interventionist policies. Historically, few countries have managed such transitions well, even in the best of times.

Efforts to slow the overheating economies, and avoid the potentially destabilising effects of higher prices, continue, putting further downward pressure on growth.

In China, data continue to show weak consumer confidence and insufficiently-strong consumption growth: yet Consensus for 2012 shows little change.

In Japan, Consensus has risen slightly for 2011, in response to local events, and has moderated downwards for 2012, in line with our expectations.

Primary exporters

There is now concrete evidence of a mounting slowdown in the primary exporting economies. PMI data are weak, OECD composite leading indicators have turned down, September saw the biggest falls since 2008 in commodity prices (CRB index), and stock markets have shown considerable weakness; all this points to a deeper slowdown than currently envisaged by Consensus. This stands to affect Latin America in particular.

Bond markets now reflect expectations of a major slowdown of the global economy and associated high risk premia. Yields are thereby unlikely to decline significantly further.

Global bond yields are holding near record lows, due to expectations of a major global economic slowdown over the coming year. However, with inflation trending higher in many countries and sovereign debt burdens rising rapidly, yields are unlikely to decline much from here, if at all.

The US Fed's decision to extend the average maturity of its Treasury holdings has had little impact, most probably because this action was well anticipated.

At the margin, the rebuilding effort in Japan is likely to place some upward pressure on global bond yields as Japan's net savings position declines.

Additional dollar weakness is likely, vis-à-vis most currencies.

Recent dollar strength reflects a global rush into liquidity associated with sharp declines in risk assets generally. This is comparable in key respects to what occurred in late 2008.

In our view, the dollar's bounce is likely to be temporary. As the US continues to face a major deterioration in its fiscal position, and remains heavily reliant on foreign financing, the dollar is likely to come under further downward pressure vis-à-vis most currencies in late 2011, and in 2012.

With the notable exceptions of the Chinese renminbi and Japanese yen, Asian currencies have weakened of late. China is unlikely to allow the renminbi to continue to appreciate vis-à-vis the USD until this situation reverses.

Tighter UK fiscal policy supports sterling and gilts.

Assuming, as we do, that UK fiscal consolidation continues apace into 2012, this would be supportive of sterling and gilts. However, any indications that the coalition government was struggling with its cost-cutting programme would be potentially negative.

Financial markets have now priced out further rate hikes in the UK, which has lent some support to gilts. The potential for a further decline in gilt yields is accordingly limited, without a dramatic decline in inflation.

The continuing decline in global equity markets has adjusted valuations to more sensible levels. However, profit expectations remain unreasonably high, implying more downside as the global slowdown unfolds.

While equity markets have naturally adjusted to reflect increasing expectations of a major global economic slowdown, we are surprised by the optimism implicit in corporate profit expectations for 2012. Should earnings disappoint, this would expose more potential downside for equity markets.

Cyclical and financial shares have suffered in particular of late, which is consistent with recent developments. However, much of the relative adjustment has probably now taken place, leaving these sectors more fairly valued relative to others.

Recent weakness in global commodity prices is consistent with a slowing global economy. The relative outperformance of precious metals is warranted, however, given sovereign debt sustainability concerns.

The fall in commodity prices in recent weeks, led by industrial metals, is most probably due to concerns that the global economic slowdown is becoming more pronounced in the BRICs. Gold has held up relatively better, although it too has declined as the dollar, in general, has been stronger.

The outperformance of gold probably has further to run in the near term, but indications that governments are taking credible action to get deficits under control would most probably lead to a sharp pullback in precious metals prices.

Worsening sovereign debt dynamics, a cyclical global downturn, and trade and currency disputes could continue to weigh on asset valuations generally.

Recent developments reinforce our concern that a potential 'perfect storm' of negative factors, the combination of which has yet to be priced into financial markets, could materialise by 2012.

Unlike in 2008, when fiscal and monetary policies were both able to address the immediate issues, this is not going to be the case over the coming year.

Recent rhetoric between the US and China is particularly worrying. The last thing the global economy needs now is a major trade war, which would have severe negative consequences for confidence and growth.■

Our main differences from consensus

- **2011: weaker for Europe (by 0.2pp) and more so for Germany (-0.6pp), and periphery (-0.5pp)**
- **2012: consensus remains implausibly strong – particularly for the US and Europe's periphery**
- **For Asia, we are below consensus by 0.4pp for this year, and by 1.0 pp for 2012**

Economic summary

- The recent marked shift in the consensus outlook is starting to reflect the atypical nature of this recovery
- In the US in particular, private sector confidence has not returned: and policy cannot force people to spend money
- Core Europe's growth appears to have peaked, and in the periphery the trough has yet to be reached
- Growth in developed economies stands to be muted for longer: in contrast to recovery from a 'normal' recession
- Domestic demand in Asia is not yet large enough to take over as growth engine of the world
- **Risks:** Further financial and real instability in late 2011 or 2012, and a sharper than expected slowdown in China

Market summary (provided by Amphora Capital)

- **Policy rates and bond yields:** Bond markets now reflect expectations of a major slowdown of the global economy, and associated high risk premia. Yields are thereby unlikely to decline further.
- **FX:** Additional dollar weakness is likely, vis-à-vis most currencies. **Sterling and gilts:** Tighter UK fiscal policy supports both.
- **Equities:** The recent sharp decline in global equity markets has adjusted valuations to more sensible levels. However, profit expectations remain unreasonably high, implying more downside as the global slowdown unfolds.
- **Commodities:** Recent weakness in global commodity prices is consistent with a slowing global economy. The relative outperformance of precious metals is warranted, however, given sovereign debt sustainability concerns.
- **Risks:** Worsening sovereign debt dynamics, a cyclical global downturn, and trade and currency disputes could continue to weigh on asset valuations

Region	Weight in world GDP	Real GDP growth (%y-o-y)					Difference from consensus (percentage points)	
		Actual		Forecast				
	2010	Average 1989-07	2009	2010	2011	2012	2011	2012
Europe	29	-	-4.1	2.0	2.0	1.6	-0.2	-0.3
Euro area	19	2.2	-4.0	1.7	1.5	1.1	-0.3	-0.3
Germany	5	1.9	-5.0	3.6	2.8	1.9	-0.6	0.0
France	4	2.0	-2.2	1.5	1.6	1.5	-0.3	-0.2
UK	4	2.4	-4.9	1.3	1.3	1.5	0.0	-0.5
Italy	3	1.4	-5.0	1.1	0.8	0.5	0.0	-0.3
Periphery*	3	3.4	-3.7	-0.6	-0.8	-0.7	-0.5	-1.2
North America	26	-	-2.5	2.8	1.9	1.5	0.0	-0.9
US	23	2.9	-2.4	2.8	1.8	1.5	0.0	-0.9
Canada	3	2.6	-2.6	3.1	2.4	1.7	-0.3	-0.8
Asia	27	-	1.5	7.2	4.5	5.1	-0.4	-1.0
Japan	9	1.6	-5.2	3.9	-0.7	2.8	0.0	-0.3
China	9	10.0	8.7	10.3	8.2	6.8	-1.0	-2.0
India	2	6.3	5.7	8.6	7.4	6.4	-0.3	-1.7
Latin America	8	-	-2.0	6.0	4.1	3.4	-0.3	-0.8
Brazil	3	2.5	-0.2	7.5	3.8	3.6	-0.1	-0.5
Other	11	-	-2.0	3.8	4.1	3.9	0.0	-0.6
Global	100	-	-1.9	4.0	3.0	2.9	-0.2	-0.7

* a (weighted) average of Greece, Ireland, Portugal and Spain
Regional weights may not sum to 100 due to rounding.
The cut off date for information is 5 September 2011.

FX rate	Policy rate	10y yield	Equities*
Mid 2012			
1.45	1.25%	2.2%	N
1.65	1.0%	2.6%	N
N/A	0.25%	2.4%	N
0.96	1.25%	2.5%	N
72	0.1%	1.0%	O
6.0	3.5%	N/A	U
42	6.0%	N/A	U
1.60	9.5%	N/A	N

* O = overweight, U = underweight, N = neutral

Slow growth in the West, the product of synchronous de-leveraging and austerity measures, stands to impact Asia's fast growing export orientated economies, and slow global growth into 2012.

The US

Consensus GDP growth fell considerably (0.6pp) last month for both 2011 and 2012. This matches our numbers for 2011, but we expect slower than consensus growth for 2012.

While the large fiscal and monetary expansion prevented what would have almost certainly been a great depression, and while the economy has bottomed out, it has not engendered a return of buoyant private sector confidence. Real final demand, when adjusted for the business cycle, is weak, unemployment is high – and it is not clear where growth can be expected to come from.

US gross government debt is high – 94% of GDP in 2010 (OECD definition i.e. inclusive of state and local government debt). And it is projected to rise above 100% this year. Furthermore, the on-balance-sheet liabilities of Fanny May and Freddie Mac amount to a further 12% of US GDP. And off-balance sheet contingent liabilities, mainly guarantees and mortgage-backed-securities held by third parties, probably amount to a further 30%-odd of US GDP.

The rebound/recovery stands to be slower and more grudging than that which typically follows a more normal (non-balance sheet) recession. And the downside risks from not implementing credible debt and deficit reduction policy are growing.

We maintain our below-consensus view for 2012.

Europe

Weak second quarter figures for Europe's core contrast sharply with the strong growth in the first quarter. Notwithstanding, projected public debt for 2011 for the euro area in aggregate is lower than for the US, and Europe's growth could outperform the US.

Criticisms of recent policies for 'merely' buying time, and prolonging the inevitable haircut, debt re-profiling, or whatever, miss the point that time is needed to recapitalise the banking sector, and enact the structural reforms that are crucial for putting the periphery economies on a sustainable growth footing.

That said, much time has now passed, and although the euro area's core is determined at top level, disparities amongst the European Union's 27 member countries, and their seeming inability and often unwillingness to pull together as a unified force, continues to undermine market confidence.

Europe has the tools to deal with its regional crisis; but would not if confidence were lost at the regional level.

Fixing that would require the G20.

We retain our below-consensus view for both 2011 and 2012.

Asia

The high growth rates of the past decade stand to be difficult to maintain in the face of a Western slowdown. The restructurings and economic diversification required to re-focus economies towards a more domestic demand orientation take time, and require interventionist policies. Historically, few countries have managed such transitions well, even in the best of times.

Efforts to slow the overheating economies, and avoid the potentially destabilising effects of higher prices, continue, putting further downward pressure on growth.

In China, data continue to show weak consumer confidence and insufficiently-strong consumption growth: but consensus for 2012 shows little change.

In Japan, consensus has come down to a 0.7% GDP decline for 2011, and has moderated upwards once again, albeit we believe rather optimistically for 2012, to 3.1%, when rebuilding stands to support growth.

Latin America

The primary exporting economies of the region, in particular, stand to be affected by softening commodity prices. Consensus has come in our direction, but we still judge that it is overstating the likely growth of the region.

Global

We project global growth of just over 3% for 2011, and a little slower in 2012.■

Bond markets now reflect expectations of a major slowdown of the global economy and associated high risk premia. Yields are thereby unlikely to decline further.

The recent, dramatic decline in major-market bond yields reflects growing expectations for a major global economic slowdown over the coming year. However, with inflation rates trending higher in many countries and sovereign debt burdens growing rapidly, yields are unlikely to decline much from here, if at all.

The Fed's pledge to hold interest rates low through at least 2013 has supported a flattening of the US yield curve which, in turn, has influenced curves elsewhere.

At the margin, the rebuilding effort in Japan is likely to place some upward pressure on global bond yields as Japan's net savings position declines.

Additional dollar weakness is likely, vis-à-vis most currencies.

The dollar has been quite stable relative to most major currencies in recent weeks, notwithstanding weak US economic data, although this is due in part to intervention by the authorities – Japan and Switzerland, for example.

In our view, this is only going to buy some time. As the US continues to face a major deterioration in its fiscal position, and remains heavily reliant on foreign financing, the dollar is likely to come under further downward pressure vis-à-vis most currencies in late 2011, and 2012.

China continues to allow a gradual strengthening of the renminbi, most probably due to high domestic price inflation. This is lending some indirect support to the yen, with direct support coming from the post-earthquake rebuilding effort.

Tighter UK fiscal policy supports sterling and gilts.

Assuming, as we do, that UK fiscal consolidation continues apace into 2012, this would be supportive of sterling and gilts. However, any indications that the coalition government was struggling with its cost-cutting programme would be potentially negative.

Financial markets have now priced out further rate hikes in the UK, which has lent some support to gilts. The potential for a further decline in gilt yields is accordingly limited, without a dramatic decline in inflation.

The recent, sharp decline in global equity markets has adjusted valuations to more sensible levels. However, profit expectations remain unreasonably high, implying more downside as the global slowdown unfolds.

While equity markets have naturally adjusted to reflect increasing expectations of a major global economic slowdown, we are surprised by the optimism implicit in corporate profit expectations for 2012. Should earnings disappoint, this would expose more potential downside for equity markets.

Cyclical and financial shares have suffered in particular of late, which is consistent with recent developments. However, much of the relative adjustment has probably now taken place, leaving these sectors more fairly valued relative to others.

Recent weakness in global commodity prices is consistent with a slowing global economy. The relative outperformance of precious metals is warranted, however, given sovereign debt sustainability concerns.

It may surprise some that, notwithstanding the sharp decline in equity markets, industrial commodities have seen only moderate weakness. However, they have underperformed sharply relative to non-industrial commodities, in particular precious metals but also agricultural and soft commodities.

This trend probably has further to run in the near-term, but indications that governments are taking credible action to get deficits under control would most probably lead to a sharp pullback in precious metals prices.

Worsening sovereign debt dynamics, a cyclical global downturn, and trade and currency disputes could continue to weigh on asset valuations generally.

Recent developments reinforce our concern that a potential 'perfect storm' of negative factors, the combination of which has yet to be priced into financial markets, could materialise by 2012.

Unlike in 2008, when fiscal and monetary policies were both able to address the immediate issues, this is not going to be the case over the coming year.

With no policy backstop, asset price adjustments might be dramatic. We continue to recommend unusually high caution.■

AMPHORA CAPITAL LLP

Protecting Wealth | Ensuring Liquidity

Our main differences from consensus

- We judge that the consensus for growth globally is too strong, particularly in 2012
- Most economists are analysing this recovery as if it were a typical recession: but it is not
- Moreover, we are increasingly concerned about US public debt, and the political inability to address it

Economic summary

- In briskly growing Asia, efforts are directed at slowing inflation. They seem likely to succeed
- Growth in developed economies stands to be muted – in contrast to a recovery from a ‘normal’ recession
- In the US, private sector confidence has not returned; and in core Europe export-led growth may have peaked
- 2012 stands to be driven by continued and widespread public and private deleveraging
- **Risks:** Financial and real instability in late 2011 or 2012, unless credible policy moves are taken to address debt levels

Market summary (provided by Amphora Capital)

- **Policy rates and bond yields:** Concerns about sovereign debt sustainability and rising inflation rates are likely to prevent a material decline in bond yields in 2011, even as the global economy slows
- **FX:** Additional dollar weakness is likely, vis-à-vis most currencies. **Sterling and gilts:** Tighter UK fiscal policy supports both
- **Equities:** Accumulating evidence of global growth deceleration stands to continue weighing on equities, with cyclical and financials at greatest risk
- **Commodities:** With clear signs of slowing global growth, commodity prices have likely peaked, in particular industrial commodities. More defensive commodities, such as gold, may continue to rise in dollar terms as long as the dollar remains weak
- **Risks:** A sharper than expected downturn in global growth, combined with the margin squeeze implied by the previous surge in commodity prices, leads to sharply weaker earnings growth and lower equity prices

Region	Weight in world GDP	Real GDP growth (%y-o-y)					Difference from consensus (percentage points)	
		Actual		Forecast				
	2010	Average 1989-07	2009	2010	2011	2012	2011	2012
Europe	29	-	-4.1	2.0	2.1	1.7	-0.1	-0.3
Euro area	19	2.2	-4.0	1.7	1.7	1.2	-0.1	-0.4
Germany	5	1.9	-5.0	3.6	3.3	2.0	0.0	0.0
France	4	2.0	-2.2	1.5	2.0	1.7	0.0	0.0
UK	4	2.4	-4.9	1.3	1.5	1.6	-0.1	-0.5
Italy	3	1.4	-5.0	1.1	0.9	0.9	0.0	-0.2
Periphery*	3	3.4	-3.7	-0.6	-1.1	-1.2	-0.8	-2.0
North America	26	-	-2.5	2.8	2.1	1.7	-0.4	-1.3
US	23	2.9	-2.4	2.8	2.1	1.7	-0.4	-1.4
Canada	3	2.6	-2.6	3.1	2.5	1.8	-0.3	-0.8
Asia	27	-	1.5	7.2	4.5	5.2	-0.4	-1.0
Japan	9	1.6	-5.2	3.9	-0.7	2.9	0.0	-0.3
China	9	10.0	8.7	10.3	8.2	6.8	-1.0	-2.0
India	2	6.3	5.7	8.6	7.7	6.7	-0.3	-1.7
Latin America	8	-	-2.0	6.0	4.1	3.5	-0.4	-0.8
Brazil	3	2.5	-0.2	7.5	3.8	3.6	-0.3	-0.6
Other	11	-	-2.0	3.8	4.3	4.0	0.0	-0.6
Global	100	-	-1.9	4.0	3.1	3.0	-0.3	-0.8

* a (weighted) average of Greece, Ireland, Portugal and Spain

Regional weights may not sum to 100 due to rounding

(The cut off date for information is 7 July 2011)

FX rate	Policy rate	10y yield	Equities*
End 2011			
1.45	1.5%	3.0%	U
1.65	1.0%	3.5%	N
N/A	0.25%	3.5%	U
0.96	1.5%	3.6%	U
76	0.1%	1.5%	O
6.0	3.5%	N/A	U
42	6.5%	N/A	U
1.65	10.5%	N/A	N

* O = overweight, U = underweight, N = neutral

The world economy is a story of two halves. Growth in the emerging economies seems set to remain brisk, albeit slowing a little, as policymakers counter inflation pressures. In the developed economies, by contrast, growth will be contained, probably for some years yet, by continued de-leveraging.

Asia

Efforts continue to slow overheating economies, so as to avoid the potentially destabilising consequences.

In China, growth seems likely to remain strong this year, slowing only marginally. That said, the recent signs of stress in the financial sector, combined with low consumption growth, and the particular vulnerability of the country's GDP growth to a slowdown in investment, continue to lead us to be more negative than Consensus, notwithstanding the relatively greater room for manoeuvre available to China's policymakers.

Japan, hit harder by the natural disasters than we had at first thought likely, is now showing strong signs of a rebound. Growth in 2012 could well be around 3%.

For Asia as a whole, Consensus is moving in our direction, and we expect rising interest rates and currency appreciation to continue moderating growth through 2012.

In the West, the wearing-off of fiscal stimulus, lack of fiscal headroom, and synchronised fiscal tightening stand to moderate growth further. Policy will be coloured in a way not seen since WWII – all about debt arithmetic and sovereign/credit risk.

The US

While the large fiscal and monetary expansion prevented what would have almost certainly been a great depression, and while the economy has bottomed out and has turned up, it has not engendered a return of buoyant private sector confidence.

Real final demand is weak for this stage of the business cycle – particularly in the housing market, where prices are still over 25% down from their (2007) peak.

Public debt, inclusive of State and local government debt, stands to rise above 100% of GDP in 2012. Furthermore, the (on-balance-sheet) liabilities of Fannie May and Freddie Mac amount to a further 12% of US GDP, and off-balance sheet contingent liabilities, mainly

guarantees and mortgage-backed-securities held by third parties, are another 30%-odd of US GDP.

Even the modest deleveraging in train so far stands to produce a recovery that is slower and more grudging than that which typically follows a more normal (non-balance sheet) recession. Moreover, downside risks from not implementing credible public deficit and debt reduction policy are mounting.

Consensus continues to move in our direction, and we maintain our below-consensus view of soggy below-par growth, for both 2011 and 2012.

Europe

Consensus GDP growth has increased this past month by around half a percentage point for Germany and France, materially raising Europe's growth expectations for the year.

Expectations for the economies of the periphery, however, continue to fall, except in Spain, the periphery's largest economy, where growth, although slow, has been positive in recent quarters.

EU determination not to have a sovereign default, strongly echoed by the new Managing Director of the IMF, Christine Lagarde, is consistent with our judgement that the euro area will continue to hold together. Moreover, criticisms of recent policies for 'merely' buying time, and prolonging the inevitable haircut or debt re-profiling, short change the point that time is needed to recapitalise the banking sector, and enact the structural reforms that are crucial for putting the periphery economies on a sustainable growth footing.

Taken as a whole the Euro area is not in too bad a shape: for example, projected public debt for 2011 is lower than for the US. However, by systematically failing to take decisions until the eleventh hour, and wrangling all the while, Europe's leaders are doing no good at all for their region's 'animal spirits'.

Next year stands to see a slowing core, and a miserable periphery: a two-speed Europe for which it will not be easy to make policy.

Latin America

The primary exporting economies in particular stand to be affected by softening commodity prices.

We maintain our view that consensus is overstating the likely growth of the region.■

Concerns about sovereign debt sustainability and rising inflation rates are likely to prevent a material decline in bond yields in 2011, even as the global economy slows

Although a slowing global economy would normally imply lower bond yields, with both inflation rates and concerns about debt sustainability now rising across most of the developed world, we doubt that there is much room for bond yields to decline much further.

This could change were inflation to begin to slow or, alternatively, if there were a greater push toward fiscal consolidation in the US and Japan.

The ECB is likely to raise rates once or possibly twice more, this year, but then pause. However, it is likely to find itself alone among major central banks, the rest of which, including the UK, are unlikely to tighten policy. With short rates remaining low but sovereign debt burdens growing and inflation rates creeping higher, yield curves are likely to remain unusually steep.

At the margin, the rebuilding effort in Japan is likely to place further upward pressure on global bond yields as Japan's net savings position declines in 2011 and 2012.

Additional dollar weakness is likely, vis-à-vis most currencies

As the US now faces a major deterioration in its fiscal position, and remains heavily reliant on foreign financing, the dollar is likely to come under more downward pressure vis-à-vis most currencies. While the dollar downtrend recently came to a pause amidst general financial market weakness, we expect it to resume in H2 2011.

Emerging market economies with high inflation, including China and India, are most probably going to allow additional currency appreciation this year. This is likely indirectly to support the yen, with direct support coming from the domestic rebuilding effort.

Tighter UK fiscal policy supports sterling and gilts.

Sterling has been particularly weak lately amidst signs the BoE may not begin to raise rates this year, and the prospect of wide public-sector strikes over the summer. As long as the government continues to deliver on its cost-cutting programme and faces down the strikes, we do not expect additional sterling weakness. A stable currency would be supportive of gilts.

Accumulating evidence of global growth deceleration stands to continue weighing on equities, with cyclical and financials at greatest risk

Recent equity market weakness appears to be a direct consequence of a sharp deterioration in global growth prospects for this year and next. That said, we judge that this has further to run; and the coming margin squeeze implied by the surge in global commodities prices in 2010 and early 2011 has yet to be properly reflected in valuations, in our view. We therefore remain cautious on global equity markets.

Cyclicals remain at risk primarily due to slowing growth; financials primarily due to sovereign risk premia, which complicate bank recapitalisation efforts.

With clear signs of slowing global growth, commodity prices, in particular industrial commodities, have likely peaked. More defensive commodities, such as gold, may continue to rise in dollar terms as long as the dollar remains weak

The surge in global commodity prices began in mid-2010, driven by a combination of accelerating global growth and rising inflation pressures. Commodity prices slumped in May, however, as evidence of slowing global growth mounted.

Worsening sovereign debt dynamics, a cyclical global downturn, and growing trade and currency disputes could weigh on asset valuations generally.

A range of risks, from a slowing global economy, high developed economy sovereign debt burdens, and escalating trade and currency disputes, may converge in late 2011 and 2012, resulting potentially in a "perfect storm" of negative factors, the combination of which has yet to be seen.

Unlike in 2008, when fiscal and monetary policy were both able to address the immediate crisis issues, this is not going to be the case in 2012.

With no policy backstop, asset price adjustments might be dramatic. We would recommend unusually high caution. ■



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Our main differences from consensus

- We think that the consensus is too strong – by far – for growth, particularly in the US and the euro area
- Most economists are analysing this recovery as if it were a typical recession: but it is not
- Moreover, we are increasingly concerned about US public debt, and the political inability to address it

Economic summary

- In briskly growing Asia, efforts are directed at slowing inflation, with pressures in China for further currency appreciation.
- Growth in developed economies by contrast stands to be muted: in contrast to a recovery from a 'normal' recession
- In the US in particular, private sector confidence has not returned, and the recovery looks typical of a balance sheet recession
- Growth in core Europe appears to have peaked, and in the periphery the trough has not yet been reached
- 2012 stands to be driven by continued and widespread concerns about public debt and deficits, particularly in the US
- Risks: Further financial and real instability in late 2011 or 2012 unless credible policy moves are taken to stabilise debt levels

Market summary (provided by Amphora Capital)

- **Policy rates and bond yields:** Concerns about sovereign debt sustainability and rising inflation rates are likely to prevent a material decline in bond yields in 2011, even as the global economy slows
- **FX:** Additional dollar weakness is likely, vis-à-vis most currencies. **Sterling and gilts:** Tighter UK fiscal policy supports both.
- **Equities:** Accumulating evidence of global growth deceleration is likely to weigh on equities, with cyclical and financials at greatest risk
- **Commodities:** With clear signs of slowing global growth, commodity prices have likely peaked, in particular industrial commodities. More defensive commodities, such as gold, may continue to rise in dollar terms as long as the dollar remains weak

Region	Weight in world GDP	Real GDP growth (%y-o-y)					Difference from consensus (percentage points)	
		Actual		Forecast			2011	2012
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Germany	5	1.9	-5.0	3.6	2.8	1.9	0.0	0.0
France	4	2.0	-2.2	1.5	1.6	1.7	0.0	0.0
UK	4	2.4	-4.9	1.3	1.6	1.7	-0.0	-0.5
Italy	3	1.4	-5.0	1.1	1.0	1.1	0.0	0.0
Periphery*	3	3.4	-3.7	-0.6	-2.3	-1.3	-2.1	-2.1
North America	26	-	-2.5	2.8	2.1	1.7	-0.6	-1.4
US	23	2.9	-2.4	2.8	2.1	1.7	-0.6	-1.5
Canada	3	2.6	-2.6	3.1	2.5	1.8	-0.4	-0.9
Asia	27	-	1.5	7.2	4.8	5.1	-0.3	-0.9
Japan	9	1.6	-5.2	3.9	0.0	2.5	0.0	-0.3
China	9	10.0	8.7	10.3	8.4	7.0	-0.9	-1.9
India	2	6.3	5.7	8.6	7.7	6.8	-0.3	-1.7
Latin America	8	-	-2.0	6.0	4.1	3.4	-0.4	-0.9
Brazil	3	2.5	-0.2	7.5	3.8	3.7	-0.3	-0.7
Other	11	-	-2.0	3.8	4.4	4.0	0.0	-0.6
Global	100	-	-1.9	4.0	3.1	2.9	-0.3	-0.8

* a (weighted) average of Greece, Ireland, Portugal and Spain

Regional weights may not sum to 100 due to rounding

(The cut off date for information is 1 June 2011)

FX rate	Policy rate	10y yield	Equities*
End 2011			
1.45	1.5%	3.0%	U
1.65	1.0%	3.5%	N
N/A	0.25%	3.5%	U
0.96	1.5%	3.6%	U
76	0.1%	1.5%	O
6.0	3.5%	N/A	U
42	6.5%	N/A	U
1.65	10.5%	N/A	N

* O = overweight, U = underweight, N = neutral

The world economy is a story of two halves. Growth in the emerging economies seems set to remain brisk, with policymakers battling inflation pressures, while growth in the developed economies will be contained by de-leveraging and austerity measures.

Asia

Efforts to slow the overheating economies, and avoid the potentially destabilising effects of higher prices, continue.

In China, we expect growth to remain strong this year, slowing only marginally, and the pressures for further currency rises to continue, as inflation pressures edge down but nevertheless persist. Data continue to show consumption growth at record lows, and consumer confidence weak.

In Japan, the supply disruption and economic impact from the natural disasters, and more particularly the damage to the nuclear plants, has been greater than we expected. Consensus has come down to a zero-growth expectation for 2011, and has moderated upwards, albeit we believe rather optimistically for 2012, to 2.8%, when rebuilding stands to support growth.

For the region as a whole, however, rising interest rates and currency appreciation are likely to continue to moderate growth through 2012.

In the West, the wearing-off of fiscal stimulus, lack of fiscal headroom, and synchronised austerity measures stand to moderate growth further. Policy will be coloured in a way not seen since WWII – becoming all about debt arithmetic, sovereign/credit risk, and debt restructurings.

The US

While the large fiscal and monetary expansion prevented what would have almost certainly been a great depression, and while the economy has bottomed out and has turned up, it has not engendered a return of buoyant private sector confidence.

Real final demand, when adjusted for the business cycle, is weak – particularly in the housing market, where prices have fallen by over a quarter from their 2007 peak. And the previously-strong PMIs have recently fallen sharply.

Public debt, inclusive of State and local government debt, is high in the US (92% of GDP in 2010), and projected to rise above 100% in 2012. Furthermore, the (on-balance-sheet) liabilities of Fanny May and Freddie Mac amount to a further 12% of US GDP, and off-balance sheet contingent liabilities, mainly guarantees and mortgage-backed-securities held by third parties, are another 30% of US GDP.

The rebound/recovery stands to be slower and more grudging than that which typically follows a more normal (non-balance sheet) recession. And the downside risks from not implementing credible debt and deficit reduction policy are growing.

Consensus has moved in our direction, and we maintain our below- consensus view for both 2011 and 2012.

Europe

The EU is determined, at top level, not to have a sovereign default. That said, political difficulties and frustrations are increasing, undermining market confidence. Much of this frustration, certainly in Greece, is directed more at concerns over the State's apparent inability to implement reforms effectively, than at doubt over the necessity of the policies.

Criticisms of recent policies for 'merely' buying time, and prolonging the inevitable haircut or debt re-profiling, miss the point that time is needed to recapitalise the banking sector, and enact the structural reforms that are crucial for putting the periphery economies on a sustainable growth footing.

For the Euro area in aggregate, projected public debt for 2011 is lower than for the US. Europe has the tools to deal with its regional crisis and, although much remains to be done, progress is being made.

Europe's core economies appear to have peaked, and we retain our below-consensus view for both 2011 and 2012.

Latin America

The primary exporting economies of the region, in particular, stand to be affected by softening commodity prices. We maintain our view that consensus is overstating the likely growth of the region.

Global

We project global growth of just over 3% for 2011 and just under 3% in 2012.■

Concerns about sovereign debt sustainability and rising inflation rates are likely to prevent a material decline in bond yields in 2011, even as the global economy slows

Although a slowing global economy would normally imply lower bond yields, with both inflation rates and concerns about debt sustainability now rising across most of the developed world, we doubt that there is much room for bond yields to decline much further.

This could change in the event that inflation were to begin to slow or, alternatively, if there were a greater push toward fiscal consolidation in the US and Japan.

Although European central banks are likely to raise interest rates modestly in 2011, financial markets have already priced this in to yield curves. Neither the US nor Japan is likely to raise rates this year, implying that yield curves globally will remain quite steep.

At the margin, the rebuilding effort in Japan is likely to place further upward pressure on global bond yields as Japan's net savings position declines in 2011 and 2012.

Additional dollar weakness is likely, vis-à-vis most currencies

As the US now faces a major deterioration in its fiscal position and remains heavily reliant on foreign financing, the dollar is likely to come under more downward pressure vis-à-vis most currencies. Indeed, the failure of the dollar to rally by much in recent weeks, given MENA turmoil and euro-area sovereign debt concerns, suggests that the dollar remains in a downtrend.

Emerging market economies with high inflation, including China and India, are most probably going to allow additional currency appreciation this year. This is likely indirectly to support the yen, with direct support coming from the domestic rebuilding effort.

The euro and sterling may well rise modestly vis-à-vis the dollar, with the Swiss franc remaining strong.

Tighter UK fiscal policy supports sterling and gilts.

Assuming as we do that UK fiscal consolidation continues apace in 2011, and that the BoE begins to raise rates as markets now anticipate, this would be supportive of sterling and gilts. However, any indications that the coalition government is struggling with its cost-cutting programme would be potentially negative.

Accumulating evidence of global growth deceleration is likely to weigh on equities, with cyclical and financials at greatest risk

As the global economy begins to slow, yet bond yields do not decline by much, if at all, as a result of higher sovereign risk premia and a lower Japanese savings rate, equities may come under significant downward pressure – all the more so if profit margins get squeezed from higher commodity prices.

Cyclicals are at risk primarily due to slowing growth; financials primarily due to sovereign risk premia, which complicate bank recapitalisation efforts.

With clear signs of slowing global growth, commodity prices, in particular industrial commodities, have likely peaked. More defensive commodities, such as gold, may continue to rise in dollar terms as long as the dollar remains weak

The surge in global commodity prices began in mid-2010, driven by a combination of accelerating global growth, and rising inflation pressures. Commodity prices slumped in May, however, as evidence of slowing global growth mounted.

Worsening sovereign debt dynamics, a cyclical global downturn and growing trade and currency disputes could weigh on asset valuations generally.

A range of risks, from a slowing global economy, dangerously high developed economy sovereign debt burdens, and escalating trade and currency disputes, may converge in late 2011 and 2012, resulting potentially in a "perfect storm" of negative factors, the combination of which has yet to be seen.

Unlike in 2008, when fiscal and monetary policy were both able to address the immediate crisis issues, this is not going to be the case in 2012.

With no policy backstop, asset price adjustments might be dramatic. We would recommend unusually high caution. ■

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Our main differences from consensus

- For 2011, we remain below consensus for growth, in the euro area, the US, and Japan
- For 2012, we remain concerned particularly about likely market reaction to US public debt
- The recent surge in commodity prices and rising interest rates in several major economies increases the risk of an accelerated global economic slowdown, with clear risks for global equity markets

Economic summary

- The world economy has become more inflationary, and events in the Middle East and Japan are adding to the uncertainties
- In Asia, responsible for nearly half of world growth in 2010, policymakers maintain efforts to slow the overheating
- Fiscal stimulus in the US continues to support consumption, but the recovery does not seem to be becoming self sustaining
- Core Europe continues to be supported by exports, but the periphery is being held back by synchronous austerity measures
- 2012 however stands to be driven by widespread concerns over public debt, particularly in the US
- Risks: Real economic trouble in late 2011 or 2012 unless pre-emptive policy moves are taken to stabilise debt levels

Market summary (provided by Amphora Capital)

- **Policy rates and bond yields:** Concerns about sovereign debt sustainability are likely to prevent a material decline in bond yields in 2011, even as the global economy begins to slow sharply
- **FX:** Additional dollar weakness is likely, vis-à-vis most currencies
- **Sterling and gilts:** Tighter UK fiscal policy supports both
- **Equities:** Growing signs of global growth deceleration should weigh on equities, with cyclical and financials at greatest risk
- **Commodities:** While prices may continue to rise in the near-term, as global economic growth slows, prices may begin to decline, in particular those for industrial commodities

Region	Weight in world GDP	Real GDP growth (%y-o-y)					Difference from consensus (percentage points)	
		Actual		Forecast			2011	2012
		2009	Average 1989-07	2009	2010	2011		
Europe	32	-	-4.1	2.0	1.7	1.7	-0.3	-0.3
Euro area	22	2.2	-4.0	1.7	1.2	1.2	-0.4	-0.4
Germany	6	1.9	-5.0	3.6	2.6	1.9	0.0	0.0
France	5	2.0	-2.2	1.5	1.6	1.7	0.0	0.0
UK	4	2.4	-4.9	1.3	1.7	1.6	-0.2	-0.5
Italy	4	1.4	-5.0	1.1	1.0	1.1	0.0	0.0
Periphery*	4	3.4	-3.7	-0.6	-2.1	-1.3	-2.1	-2.5
North America	27	-	-2.5	2.8	2.3	1.8	-0.8	-1.4
US	25	2.9	-2.4	2.8	2.3	1.8	-0.8	-1.5
Canada	2	2.6	-2.6	3.1	2.5	1.8	-0.4	-0.9
Asia	25	-	1.5	7.2	5.1	4.8	-0.5	-1.1
Japan	9	1.6	-5.2	3.9	1.0	1.5	-0.4	-0.6
China	8	10.0	8.7	10.3	8.4	7.0	-1.0	-2.0
India	2	6.3	5.7	8.6	7.7	6.8	-0.5	-1.6
Latin America	7	-	-2.0	6.0	3.8	3.3	-0.4	-0.9
Brazil	3	2.5	-0.2	7.5	3.8	3.7	-0.3	-0.7
Other	10	-	-2.0	3.8	4.2	4.6	0.0	0.0
Global	100	-	-1.9	4.0	3.1	2.9	-0.5	-0.8

* a (weighted) average of Greece, Ireland, Portugal and Spain

FX rate	Policy rate	10y yield	Equities*
End 2011			
1.45	1.5%	3.0%	U
1.65	1.0%	3.5%	N
N/A	0.25%	3.5%	U
0.96	1.5%	3.6%	U
76	0.1%	1.5%	O
6.0	3.5%	N/A	U
42	6.5%	N/A	U
1.65	10.5%	N/A	N

* O = overweight, U = underweight, N = neutral

(The cut off date for information is 31 March 2011)

The world economy is becoming more inflationary, particularly in fast-growing Asia, although policy moves seem now to be succeeding in moderating growth.

Asia

Asia's policymakers' efforts to slow their overheating economies, and avoid the potentially destabilising effects of higher prices, continue.

In China, price pressures are apparently moderating, and the economy slowing. Data for the first months of this year show consumption growth at record lows, consumer confidence depressed, and the saving propensity rising further. In Asia, the lack of a welfare system in much of the region encourages a culture of high saving rates, and these are prone to rising further when the economic outlook deteriorates.

In Japan, we expect recent events to reduce the country's GDP growth by around 0.3 pp in 2011 – and consensus to come down by that amount or more in the coming month or two. In 2012, however, rebuilding stands to support growth.

For the region as a whole, however, rising interest rates, and currency appreciation are likely to continue to moderate growth through 2012.

In the West, the wearing-off of fiscal stimulus, lack of fiscal headroom, and synchronised austerity measures will further moderate growth. Policy will be coloured in a way not seen since WWII – becoming all about debt arithmetic, sovereign/credit risk, and perhaps debt restructurings.

The US

The fiscal stimulus has worked, and stands to continue supporting consumption: indeed PMIs are strong, pointing to strong growth. However business capital formation remains anaemic for this stage of the business cycle, and there is clear evidence of structural problems.

House sales and permits to build are down to record low levels, unemployment levels remain high, rising prices, particularly of energy and food, are reducing real incomes, and consumer sentiment is down.

This is not consistent with a self-sustaining recovery.

Public debt levels, inclusive of State and local government debt, are high in the US (92% of GDP in 2010), and projected to rise above 100% in 2012. Furthermore, the (on-balance-sheet) liabilities of Fanny May and Freddie Mac amount to around 12% of US GDP, and off-balance sheet contingent liabilities, mainly guarantees and mortgage-backed-securities held by third parties, are around 30% of US GDP. Sustaining such levels stands to become increasingly problematic.

Consensus for 2011 has remained broadly constant, but we judge that the expected effects of the stimulus, along with US growth projections, continue to be overstated.

Europe

We are basically optimistic about Europe's prospects, at least relative to much of the English speaking media. Public debt levels in 2010 and projections are lower than for the US. Europe has the tools to deal with its regional crisis, and is making progress. That said, much remains to be done: Europe needs to strengthen its governance, fix its banks, and reform its structural policies.

Synchronised austerity measures (particularly in the economies of the periphery), and lack of fiscal headroom across Europe stand to moderate growth this year, but to some extent also in 2012.

Over the past six months consensus for Germany and France has moved in our direction, but for the euro area, and Europe as a whole, it has remained broadly constant.

Latin America

While the primary exporting economies of the region, in particular, stand to continue benefitting from higher commodity prices, we maintain our view that consensus is overstating the likely growth of the region.

Global

Convergence of negative factors, including the increasing uncertainties from events in the Middle East and Asia stand to moderate growth – and more so than is currently expected, particularly in 2012. Output will not get back to its pre-crisis trend level (it seldom does), but for a number of years yet it may not even return to its former rate. ■

Concerns about sovereign debt sustainability are likely to prevent a material decline in bond yields in 2011, even as the global economy begins to slow sharply.

Under normal circumstances, a slowing global economy would see falling rather than stable or rising government bond yields.

However, by 2012, as sovereign debt burdens across the developed world are expected to reach levels associated with escalating risks of currency devaluation or debt default, financial markets may begin to demand higher risk premia for even the highest-quality sovereign bonds.

Not only is this unusual; it is worrisome as it increases debt servicing costs at precisely the time that economies require lower borrowing costs. With central banks in developed economies generally keeping policy rates low, this implies that yield curves remain steep.

At the margin, the rebuilding effort in Japan is likely to place further upward pressure on global bond yields as Japan's net savings position declines in 2011 and 2012.

Renewed dollar weakness is likely to be spread across most currencies.

As the US now faces a major deterioration in its fiscal position and remains heavily reliant on foreign financing, the dollar is likely to come under more downward pressure vis-à-vis most currencies. Indeed, the failure of the dollar to rally on the ongoing Mideast turmoil is a sign that the dollar remains in a secular downtrend.

Certain emerging markets with high inflation, including China and India, are most probably going to allow substantial currency appreciation this year, notwithstanding recent rhetoric to the contrary. This is likely indirectly to support the yen, with direct support coming from the domestic rebuilding effort. The euro and sterling should also rise vis-à-vis the dollar, although to a lesser extent, with the Swiss franc remaining strong.

Tighter UK fiscal policy supports sterling and gilts.

Assuming as we do that UK fiscal consolidation continues apace in 2011, in an environment of sovereign debt concerns generally, this should be supportive of sterling and gilts.

However, any indications that the coalition government is struggling with its cost-cutting programme would be potentially quite negative.

Growing signs of global growth deceleration should weigh on equities, with cyclical and financials at greatest risk.

Lingering regime uncertainty most probably continues to weigh on equity valuations. As the global economy begins to slow, yet bond yields do not decline by much, if at all, as a result of higher sovereign risk premia and a lower Japanese savings rate, equities may come under significant downward pressure.

Cyclicals are at risk primarily due to slowing growth; financials primarily due to sovereign risk premia, which complicates bank recapitalisation efforts.

Commodity prices may continue to rise in the near-term but the medium-term outlook is weakening along with that for global economic growth.

The surge in global commodity prices began in mid-2010, driven by a combination of accelerating global growth and rising inflationary pressures. More recently, commodity prices have surged on geopolitical concerns.

As the global economy slows, however, commodity prices are more likely to decline, in particular those for industrial commodities.

Worsening sovereign debt dynamics combined with growing trade and currency disputes could weigh on asset valuations generally.

Looking across the range of risks, from slowing emerging markets, dangerously high developed economy sovereign debt burdens, and escalating trade and currency disputes, these would appear to converge in late 2011 and 2012, resulting potentially in a "perfect storm" of negative factors, the combination of which has yet to be seen.

Unlike in 2008, when fiscal and monetary policy were both able to substantially address the immediate crisis issues, this is not going to be the case in 2012.

With no policy backstop, asset price adjustments might be dramatic. We would recommend unusually high caution. ■

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Our main differences from consensus

- For 2011, we remain 0.4 pp below consensus for growth in the euro area, and 0.8 pp for the US
- For 2012 however, we are deeply pessimistic about market reaction to US public debt
- The recent surge in energy, food and other commodity prices increases the risk of an accelerated global economic slowdown, with clear risks for global equity markets

Economic summary

- The world economy has been growing strongly, and is becoming more inflationary
- Asia, responsible for nearly half of world growth in 2010, will be slowed by policy
- The effects of the 2009 US fiscal stimulus are wearing off; and new stimulus may help to keep growth going
- Core Europe will continue to be driven by exports to Asia, but be held back by synchronised austerity measures
- 2012 however stands to be driven by widespread concerns over public debt, particularly in the US
- Risks: Real economic trouble in late 2011 or 2012 unless pre-emptive policy moves are taken to stabilise debt levels

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		Actual		Forecast			2011	2012
		2009	Average 1989-07	2009	2010	2011	2012	
Europe	32	-	-4.1	2.0	1.6	1.6	-0.3	-0.3
Euro area	22	2.2	-4.0	1.7	1.2 ↑	1.3 ↑	-0.4	-0.4
Germany	6	1.9	-5.0	3.6	2.7	1.8	0.2	0.0
France	5	2.0	-2.2	1.5 ↓	1.8	1.8 ↑	0.2	0.0
UK	4	2.4	-4.9	1.4 ↓	1.7 ↓	1.7 ↑	-0.2	-0.5
Italy	4	1.4	-5.0	1.1 ↑	1.0 ↑	1.1	0.0	0.0
Periphery*	4	3.4	-3.7	-0.6 ↑	-3.0	-1.0	-2.9	-2.1
North America	27	-	-2.5	2.9	2.4	1.8	-0.8	-1.4
US	25	2.9	-2.4	2.9	2.4	1.8	-0.8	-1.5
Canada	2	2.6	-2.6	2.9	2.2 ↑	1.8	-0.4	-0.9
Asia	25	-	1.5	7.2 ↓	5.0 ↓	4.6	-0.3	-1.2
Japan	9	1.6	-5.2	3.9 ↓	1.3 ↑	1.0	-0.2	-1.0
China	8	10.0	8.7	10.3 ↑	8.6 ↑	6.9	-0.7	-2.0
India	2	6.3	5.7	8.7	7.9	6.8	-0.4	-1.6
Latin America	7	-	-2.0	5.8	3.7	3.3	-0.5	-1.0
Brazil	3	2.5	-0.2	7.5 ↓	3.8 ↓	3.6 ↓	-0.6	-1.0
Middle East	3	-	1.6	3.7	4.0	4.2	0.0	0.0
Other	7	-	-2.0	3.5	3.9	4.1	0.0	0.0
Global	100	-	-1.9	4.0	3.1	2.7 ↓	-0.4	-0.9

* a (weighted) average of Greece, Ireland, Portugal and Spain

FX rate	Policy rate	10y yield	Equities*
End 2011			
1.45	1.5%	3.0%	U
1.65	1.0%	3.5%	N
N/A	0.25%	3.5%	U
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6.0	3.5%	N/A	U
42	6.5%	N/A	U
1.65	10.5%	N/A	N

* O = overweight, U = underweight, N = neutral

(The cut off date for information is 1 March 2011)

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The world economy recovered strongly in 2010, and is becoming more inflationary, particularly in fast-growing Asia, where policy moves stand to put downward pressure on growth.

Asia

China, India and other Asian countries continue to tighten monetary policy in an effort to slow their overheating economies. The urgency to do so is all the greater as food price inflation stirs riots and potentially destabilises countries across the region.

Control over the renminbi's appreciation continues to channel China's productivity gains into higher inflation through imported US Quantitative Easing and lax monetary policy.

Higher interest rates and currency appreciation are likely to moderate growth through 2011 and 2012. In China, the ability to control the economy through government fiat seems to be becoming more problematic. Although optimism is higher in Asia than in Europe and the US, consumption is starting to moderate in Asia, which, in 2010, accounted for nearly half of world growth. The lack of a welfare system in much of Asia encourages a culture of high saving rates, and these are prone to rise further when the outlook deteriorates.

In the West, the wearing off of fiscal stimulus, lack of fiscal headroom, and synchronised austerity measures will further moderate growth. Policy will be coloured in a way not seen since WWII – becoming all about debt arithmetic, sovereign/credit risk, and perhaps debt restructurings.

The US

Recent data indicate that the US recovery is not self-sustaining. The housing market appears to have turned down yet again, the workforce is shrinking, and the core rate of business investment remains anaemic for the current stage of the business cycle.

We judge that, though the fiscal stimulus will support growth, its effects, along with US growth projections, may still be being overstated. Moreover, they stand to fuel public-debt worries further in 2011 or 2012.

Public debt levels, inclusive of State and local government debt, are high in the US (92% of GDP in 2010), and projected to rise above 100% in 2012.

Furthermore, the (on-balance-sheet) liabilities of Fanny May and Freddie Mac amount to around 12% of US GDP, and off-balance sheet contingent liabilities, mainly guarantees and mortgage-backed-securities held by third parties, are in the region of 30% of US GDP. Sustaining such public-debt levels stands to become problematic, even for the US. Whether markets force austerity, or policy measures pre-empt that – deficits stand to be reined impacting, perhaps heavily, on growth.

We maintain our view that US GDP growth will remain below trend for a prolonged period, hence retain our 0.8 pp below-Consensus forecast for 2011, and are substantially below for 2012.

Europe

Waning fiscal stimulus, and synchronised austerity measures (particularly in the economies of the periphery), and lack of fiscal headroom across Europe stand to moderate growth in 2011 and 2012.

Notwithstanding Europe's difficulties however, we do not believe the euro area will fall apart. German hostility towards the economies of the euro area's periphery is not as great as is often portrayed by the English speaking media; although the recent CDU defeat in the Hamburg elections increases the pressure on the German government to move quickly to create some sort of restructuring mechanism for distressed euro-area sovereign debt.

Euro area discipline stands to follow the Germanic model (simple rules) in the future. Moreover, public debt levels in 2010 and projections are lower for the euro area than the US.

Latin America

While the primary exporting economies of the region in particular, stand to continue benefitting from higher commodity prices, we still judge that Consensus is overstating the likely growth of the region.

Global

Convergence of the negative factors stands to moderate growth, more so than is currently expected, particularly in 2012. Growth will not get back to the level of its previous pre-crisis trend (it seldom does), but it may not even return to its former rate for a number of years. ■

Concerns about sovereign debt sustainability are likely to prevent a material decline in bond yields in 2011, even as the global economy begins to slow sharply.

Under normal circumstances, a slowing global economy would see falling rather than stable or rising government bond yields.

However, by 2012, as sovereign debt burdens across the developed world are expected to reach levels associated with escalating risks of currency devaluation or debt default, financial markets may begin to demand higher risk premia for even the highest-quality sovereign bonds.

Not only is this unusual; it is worrisome as it increases debt servicing costs at precisely the time that economies require lower borrowing costs. With central banks in developed economies generally keeping policy rates low, this implies that yield curves remain steep.

Renewed dollar weakness is likely to be spread across most currencies.

As the US now faces the greatest deterioration in its fiscal position and remains heavily reliant on foreign financing, the dollar is likely to come under increased downward pressure versus most currencies in 2011. Indeed, the failure of the dollar to rally on recent Mideast turmoil is a sign that the dollar remains in a secular downtrend.

Certain emerging markets with unwelcome high inflation, including China and India, are most probably going to allow substantial currency appreciation, notwithstanding recent rhetoric to the contrary. This is likely indirectly to support the yen. The euro and sterling should also rise versus the dollar, although to a lesser extent, with the Swiss franc remaining strong.

Tighter UK fiscal policy supports sterling and gilts.

Assuming as we do that UK fiscal consolidation continues apace in 2011, in an environment of sovereign debt concerns generally, this should be supportive of sterling and gilts.

However, any indications that the coalition government is struggling with its cost-cutting programme would be potentially quite negative.

Growing signs of global growth deceleration should weigh on equities, with cyclical and financials at greatest risk.

Lingering regime uncertainty most probably continues to weigh on equity valuations. As the global economy begins to slow, while bond yields do not decline by much, if at all, as a result of higher sovereign risk premia, equities may come under significant downward pressure.

Cyclicals are at risk primarily due to slowing growth; financials primarily due to sovereign risk premia, which complicates bank recapitalisation efforts.

Commodity prices may continue to rise in the near-term but the medium-term outlook is weakening along with that for global economic growth.

The surge in global commodity prices began in mid-2010, driven by a combination of accelerating global growth and rising inflationary pressures. More recently, commodity prices have surged on geopolitical concerns.

As the global economy slows, however, commodity prices are more likely to decline, in particular those for industrial commodities.

Worsening sovereign debt dynamics combined with growing trade and currency disputes could weigh on asset valuations generally.

Looking across the range of risks, from slowing emerging markets, dangerously high developed economy sovereign debt burdens, and escalating trade and currency disputes, these would appear to converge in late 2011 and 2012, resulting potentially in a “perfect storm” of negative factors, the combination of which has yet to be seen.

Unlike in 2008, when fiscal and monetary policy were both able to substantially address the immediate crisis issues, this is not going to be the case in 2012.

With no policy backstop, asset price adjustments might be dramatic. We would recommend unusually high caution. ■

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Our main differences from consensus

- For 2011, we remain 0.4 pp below consensus for growth in the euro area, and 0.8 pp for the US
- For 2012 however, we are deeply pessimistic about market reaction to US public debt
- Concerns about sovereign debt sustainability are likely to prevent a material decline in bond yields in 2011, even as the global economy begins to slow sharply

Economic summary

- The world economy has been growing strongly, and is becoming more inflationary
- Asia, responsible for nearly half of world growth in 2010, will be slowed by policy
- The effects of the 2009 US fiscal stimulus are wearing off; and new stimulus may help to keep growth going
- Core Europe will continue to be driven by exports to Asia, but be held back by synchronised austerity measures
- 2012 however stands to be driven by widespread concerns over public debt, particularly in the US
- Risks: Real financial market trouble in late 2011 or 2012 unless pre-emptive policy moves are taken

Market summary (provided by Amphora Capital)

- **Policy rates and bond yields:** Concerns about sovereign debt sustainability are likely to prevent a material decline in bond yields in 2011, even as the global economy begins to slow sharply
- **FX:** Additional dollar weakness is likely, vis-à-vis most currencies
- **Sterling and gilts:** Tighter UK fiscal policy supports both
- **Equity:** Growing signs of global growth deceleration should weigh on equities, with cyclical and financials at greatest risk
- **Risks:** Worsening sovereign debt dynamics, with growing trade and currency disputes weighing on asset valuations generally

Region	Weight in world GDP	Real GDP growth (%y-o-y)					Difference from consensus (percentage points)	
		Actual		Forecast			2011	2012
		2009	Average 1989-07	2009	2010	2011	2012	
Europe	32	-	-4.1	2.0 ↑	1.6 ↑	1.6	-0.3	-0.3
Euro area	22	2.2	-4.0	1.7 ↑	1.1 ↑	1.0	-0.4	-0.4
Germany	6	1.9	-5.0	3.6 ↑	2.6	1.8	0.3	0.0
France	5	2.0	-2.2	1.6	2.1 ↑	1.7	0.2	0.0
UK	4	2.4	-4.9	1.7	1.9 ↑	1.6	-0.2	-0.5
Italy	4	1.4	-5.0	1.0 ↓	0.9 ↓	1.1	0.0	0.0
Periphery*	4	3.4	-3.7	-0.7 ↑	-3.0	-1.0	-2.9	-2.1
North America	27	-	-2.5	2.9 ↑	2.4 ↑	1.8	-0.8	-1.4
US	25	2.9	-2.4	2.9 ↑	2.4 ↑	1.8	-0.8	-1.5
Canada	2	2.6	-2.6	2.9 ↓	2.1 ↑	1.8	-0.4	-0.9
Asia	25	-	1.5	7.3 ↑	5.1	4.6	-0.3	-1.2
Japan	9	1.6	-5.2	4.3 ↑	1.0	1.0	-0.2	-1.0
China	8	10.0	8.7	10.1	8.5 ↑	6.9	-0.7	-2.0
India	2	6.3	5.7	8.7 ↑	7.9 ↓	6.8	-0.4	-1.6
Latin America	7	-	-2.0	5.8 ↑	3.7 ↑	3.3	-0.5	-1.0
Brazil	3	2.5	-0.2	7.6	3.9	3.8	-0.6	-1.0
Middle East	3	-	1.6	3.7 ↑	4.0 ↑	4.2	0.0	0.0
Other	7	-	-2.0	3.5 ↓	3.9 ↑	4.1	0.0	0.0
Global	100	-	-1.9	4.0 ↑	3.1 ↑	2.8	-0.4	-0.9

* a (weighted) average of Greece, Ireland, Portugal and Spain

FX rate	Policy rate	10y yield	Equities*
End 2011			
1.45	1.0%	3.0%	U
1.65	0.5%	3.5%	N
N/A	0.25%	3.5%	U
0.96	1.5%	3.6%	U
76	0.1%	1.0%	N
6.0	3.5%	N/A	U
42	6.5%	N/A	U
1.65	10.5%	N/A	N

* O = overweight, U = underweight, N = neutral

The world economy recovered strongly in 2010, and is becoming more inflationary, particularly in fast-growing Asia, where policy moves stand to put downward pressure on growth.

Asia

Food riots, the uneven distribution of income, high commodity prices, and the dangers associated with overheating are causing visible concern in a range of countries. Annual inflation rates are just under 5% in China and over 8% in India; with food price inflation double-digit in both.

Continued control over the renminbi's appreciation continues to channel China's productivity gains into higher inflation through imported US Quantitative Easing and lax monetary policy.

Higher interest rates and currency appreciation are likely to moderate growth through 2011 and 2012. In China, the ability to control the economy through government fiat seems to be becoming more problematic.

Although optimism is higher in Asia than in Europe and the US, consumption is starting to moderate in Asia, which, in 2010, accounted for nearly half of world growth. The lack of a welfare system in much of Asia encourages a culture of high saving rates, and these are prone to rise even further when the outlook deteriorates.

In the West, the wearing off of fiscal stimulus, lack of fiscal headroom, and synchronised austerity measures will further moderate growth. Policy will be coloured in a way not seen since WWII – becoming all about debt arithmetic, sovereign/credit risk, and perhaps debt restructurings.

The US

The Consensus growth forecast for the US in 2011 has increased by 0.8pp, to 3.2%, since the end of last year. We judge however that, though the unexpected fiscal stimulus will support growth, its effects, along with US growth projections, may be being overstated. Moreover, they stand to fuel public-debt worries further in 2011 or 2012.

Public debt levels, inclusive of State and local government debt, are high in the US (92% of GDP in 2010), and projected to rise above 100% in 2012.

Furthermore, the (on-balance-sheet) liabilities of Fanny May and Freddie Mac amount to around 12% of US GDP, and off-balance sheet contingent liabilities, mainly guarantees and mortgage-backed-securities held by third parties, are in the region of 30% of US GDP.

Sustaining such public-debt levels stands to become problematic, even for the US. Whether markets force austerity, or policy measures pre-empt that – deficits stand to be reined impacting, perhaps heavily, on growth.

We maintain our view that US GDP growth will remain below trend for a prolonged period, hence retain our 0.8 pp below-Consensus forecast for 2011, and are substantially below for 2012.

Europe

Waning fiscal stimulus, and synchronised austerity measures (particularly in the economies of the periphery), and lack of fiscal headroom across Europe stand to moderate growth in 2011 and 2012.

Notwithstanding Europe's difficulties however, we do not believe the euro area will fall apart. German hostility towards the economies of the euro area's periphery is not as great as is often portrayed by the English speaking media.

Euro area discipline stands to follow the Germanic model (simple rules) in the future. Moreover, public debt levels in 2010 and projections are lower for the euro area than the US.

Latin America

While the primary exporting economies of the region in particular, stand to continue benefitting from higher commodity prices, we still judge that Consensus is overstating likely growth of the region.

Global

Convergence of the negative factors stands to moderate growth, more so than is currently expected, particularly in 2012.

Growth will not get back to the level of its previous pre-crisis trend (it seldom does), but it may not even return to its former rate for a number of years. ■

Concerns about sovereign debt sustainability are likely to prevent a material decline in bond yields in 2011, even as the global economy begins to slow sharply.

Under normal circumstances, a slowing global economy would see falling rather than stable or rising government bond yields.

However, by 2012, as sovereign debt burdens across the developed world are expected to reach levels associated with escalating risks of currency devaluation or debt default, financial markets may begin to demand higher risk premia for even the highest-quality sovereign bonds.

Not only is this unusual; it is worrisome as it increases debt servicing costs at precisely the time that economies require lower borrowing costs. With central banks in developed economies generally keeping policy rates low, this implies that yield curves remain steep.

Renewed dollar weakness is likely to be spread across most currencies.

As the US now faces the greatest deterioration in its fiscal position and remains heavily reliant on foreign financing, the dollar is likely to come under increased downward pressure versus most currencies in 2011.

Certain emerging markets with unwelcome high inflation, including China and India, are most probably going to allow substantial currency appreciation, notwithstanding recent rhetoric to the contrary. This is likely indirectly to support the yen. The euro and sterling should also rise versus the dollar, although to a lesser extent.

Tighter UK fiscal policy supports sterling and gilts.

Assuming as we do that UK fiscal consolidation continues apace in 2011, in an environment of sovereign debt concerns generally, this should be supportive of sterling and gilts.

However, any indications that the coalition government is struggling with its cost-cutting programme would be potentially quite negative.

Growing signs of global growth deceleration should weigh on equities, with cyclical and financials at greatest risk.

Lingering regime uncertainty most probably continues to weigh on equity valuations. As the global economy begins to slow, while bond yields do not decline by much, if at all, as a result of higher sovereign risk premia, equities may come under significant downward pressure.

Cyclicals are at risk primarily due to slowing growth; financials primarily due to sovereign risk premia, which complicates bank recapitalisation efforts.

Worsening sovereign debt dynamics combined with growing trade and currency disputes could weigh on asset valuations generally.

Looking across the range of risks, from slowing emerging markets, dangerously high developed economy sovereign debt burdens, and escalating trade and currency disputes, these would appear to converge in late 2011 and 2012, resulting potentially in a “perfect storm” of negative factors, the combination of which has yet to be seen.

Unlike in 2008, when fiscal and monetary policy were both able to substantially address the immediate crisis issues, this is not going to be the case in 2012.

With no policy backstop, asset price adjustments might be dramatic. We would recommend unusually high caution. ■

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