



Investment outlook

Ian Kernohan, Economist

Key points

- Global economic growth set to remain high, supported by emerging economies and stronger momentum in US and Northern Europe
- Inflation to remain low in most developed economies, but above target in the UK
- Expect UK interest rates to rise in 2011
- We remain positive on credit relative to government bonds

Global economic recovery set to continue

The global economy has recovered over the past year, and at a faster pace than many expected. Emerging economies provided the initial impetus to recovery, however recent data suggests stronger momentum in the advanced economies, particularly the US and Germany.

Going forward, we are assuming that recovery in the developed world remains somewhat constrained by deleveraging in household and public sectors. However, we do not expect a return to recessionary conditions in these economies and we expect growth in much of the emerging world, led by Asia, to remain strong.

There are risks on either side of our central case: downside risks include renewed recession in the developed world, another financial crisis, and a sharp slowdown in China. An upside risk would be much stronger economic growth in the developed world than we expect, in effect a speedy return to pre-recessionary conditions. Such an outcome would however result in an earlier tightening in monetary policy than we expect.

Inflation and growth – how will they impact interest rates?

Aside from the UK, we expect developed world inflation to stay low, given the scale of spare capacity. Even in the UK, where inflation is set to stay above target thanks in part to a second rise in VAT, we do not expect underlying inflationary conditions to gain traction. Sustained periods of high inflation in the UK typically result from too rapid economic growth relative to supply, which leads to a marked tightening in labour market conditions.

An even more important factor in maintaining low inflation is the credibility of the inflation target and we expect the BOE to raise rates in 2011 in order to maintain its anti-inflationary credentials. Were the BOE not to act, assuming the economy continues to grow at a reasonable rate, there would be a serious risk that high inflation expectations would become ingrained.

We do not expect policy tightening in the US during 2011, given the high level of unemployment and low level of inflation. In all developed economies, we expect interest rates to plateau at a very low level when compared with recent history, thanks to a combination of the pressure of fiscal restraint (in some economies) and continued fragility in the banking sector.

The outlook for the main bond asset classes

Assuming no double-dip event or major financial crisis, the economic background remains supportive for corporate credit, aided by strong corporate balance sheets and low yields on cash and government bonds.

During the last quarter, credit spreads widened and at current levels, we would argue in favour of an overweight position in corporate credit. December saw global bond markets marginally weaken on signs of stronger global economic growth. In the UK, government bonds returned -0.1% whilst credit spreads were marginally tighter on the month. The best area was index-linked bonds where breakeven implied inflation rates widened i.e. investors wanted more inflation protection.

As expected, government bond yields have risen, however given our view that interest rates will remain relatively low for some time, we are not forecasting a major sell off in government bond markets over the next 12 months.

Source: rlam as at 12 January 2011 unless otherwise stated.

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