The Institute of Risk Management

The Economic and Financial Outlook – Recovery or Relapse?

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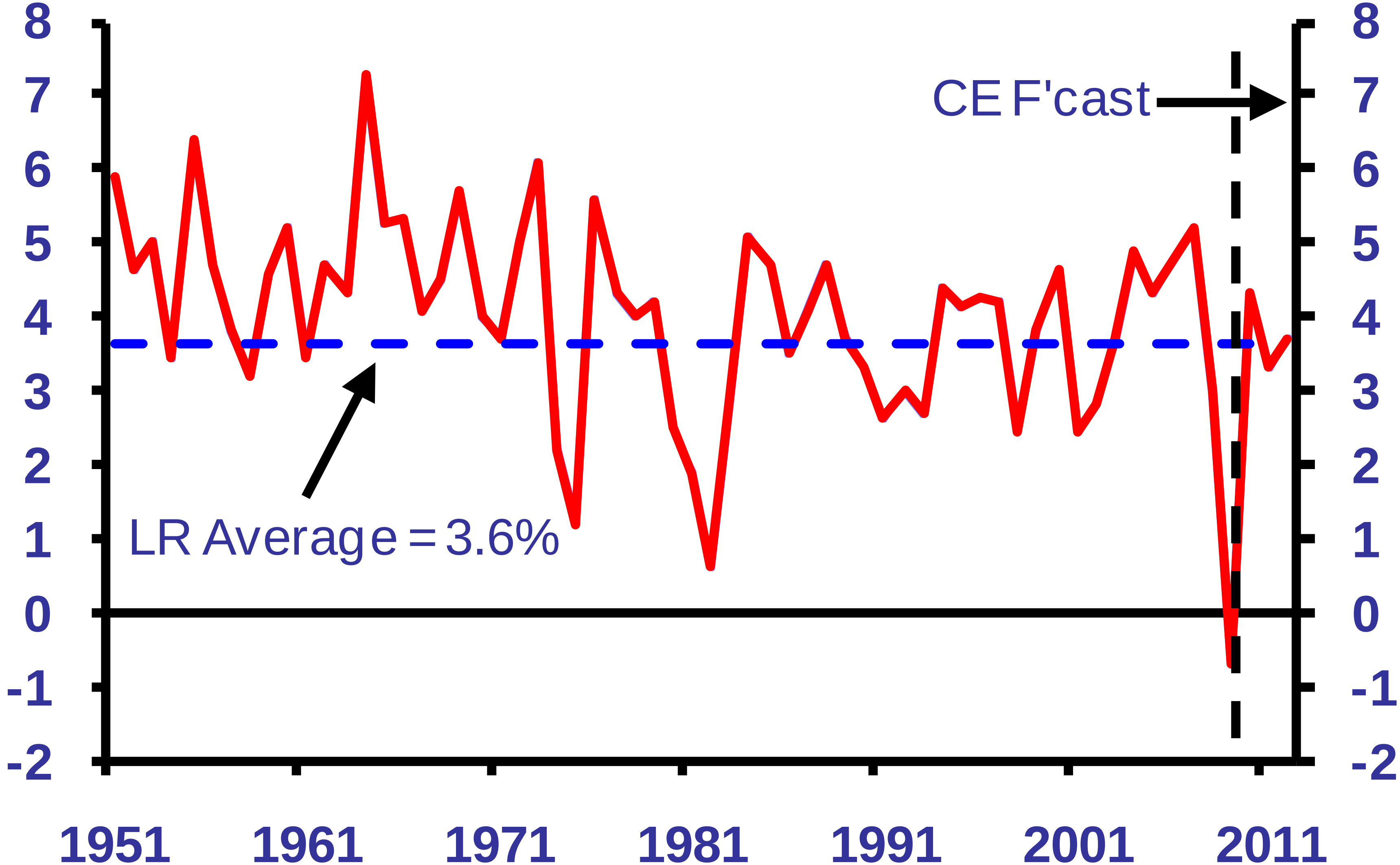
Risk Leaders' Conference

19 November 2010

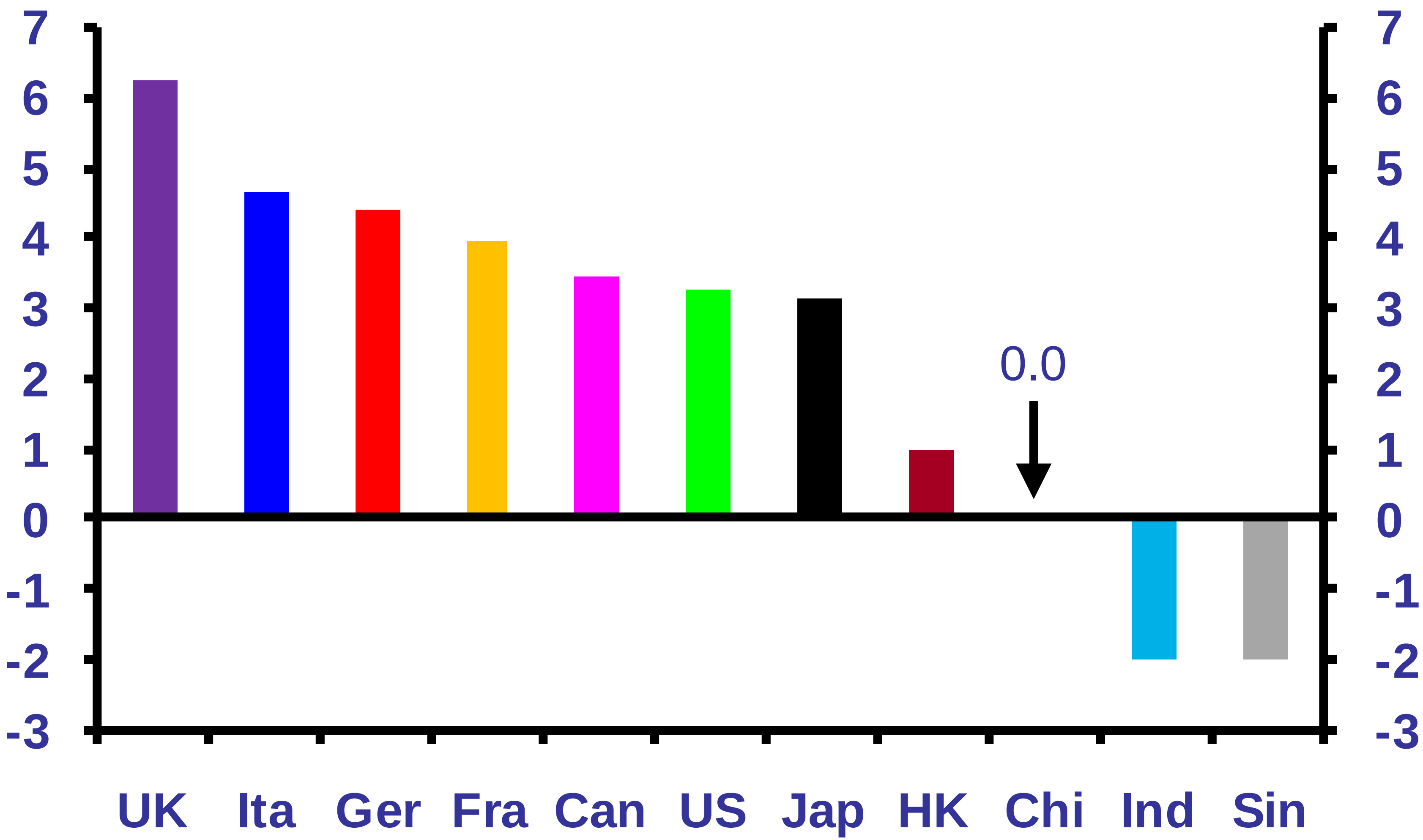
Leading the risk profession

1. World GDP (% y/y) (1951 – 2012)



Source: Maddisson, IMF, Capital Economics

2. Spare Capacity (As a % of GDP, 2010)



Source: OECD

3. The recovery initially driven by one-off factors

- The inventory bounce.
- The revived availability of finance.
- Massive fiscal and monetary stimulus.
- So a subsequent slowdown – if not a double-dip – was always on the cards.

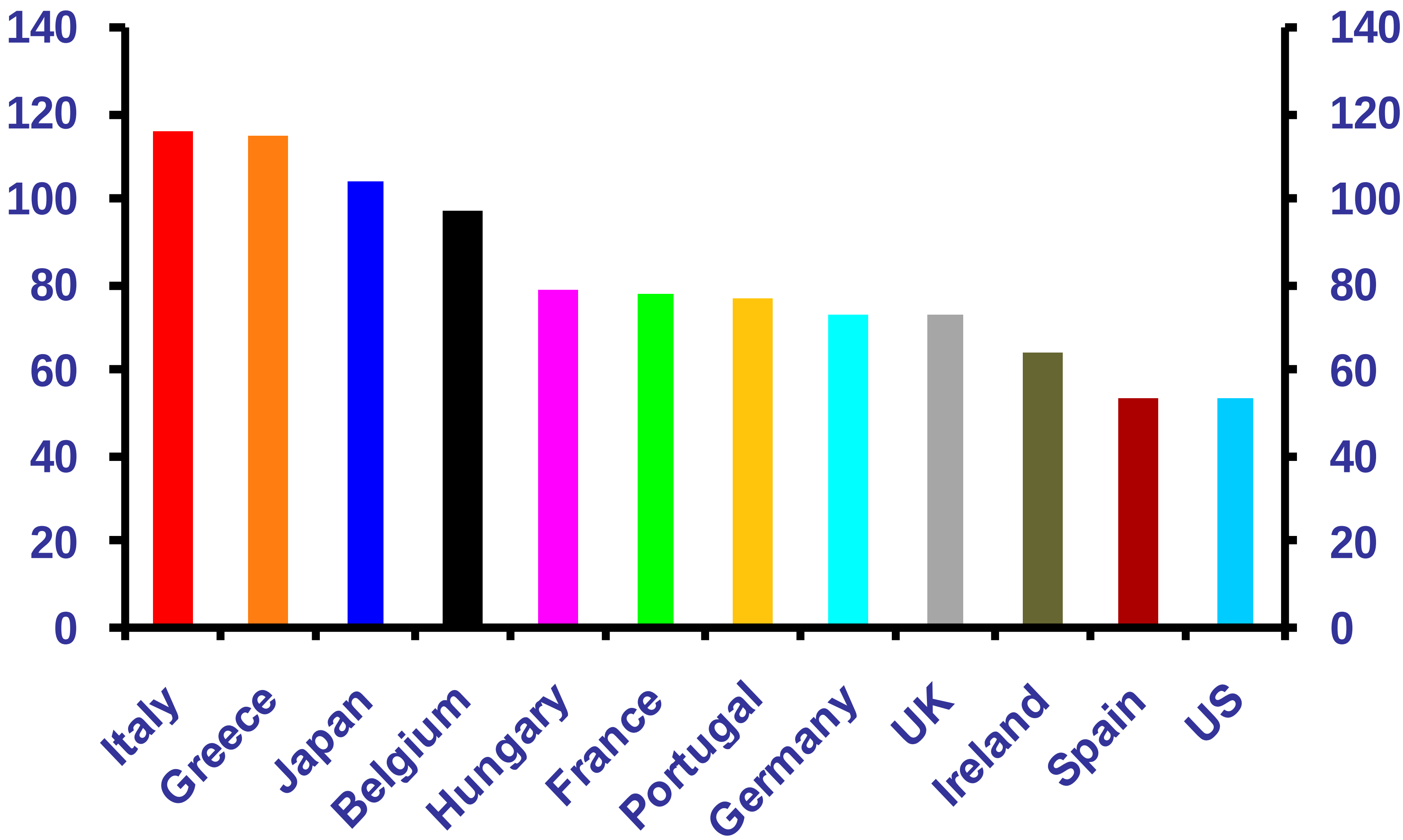
4. What sort of downturn?

- Reduced output not the result of destroyed buildings or the wipe-out of millions of people.
- Nevertheless, reduced supply capacity?
- The downturn is the result of reduced demand.
- Thoroughly man-made. Could be unmade?

5. The Reluctant Spenders

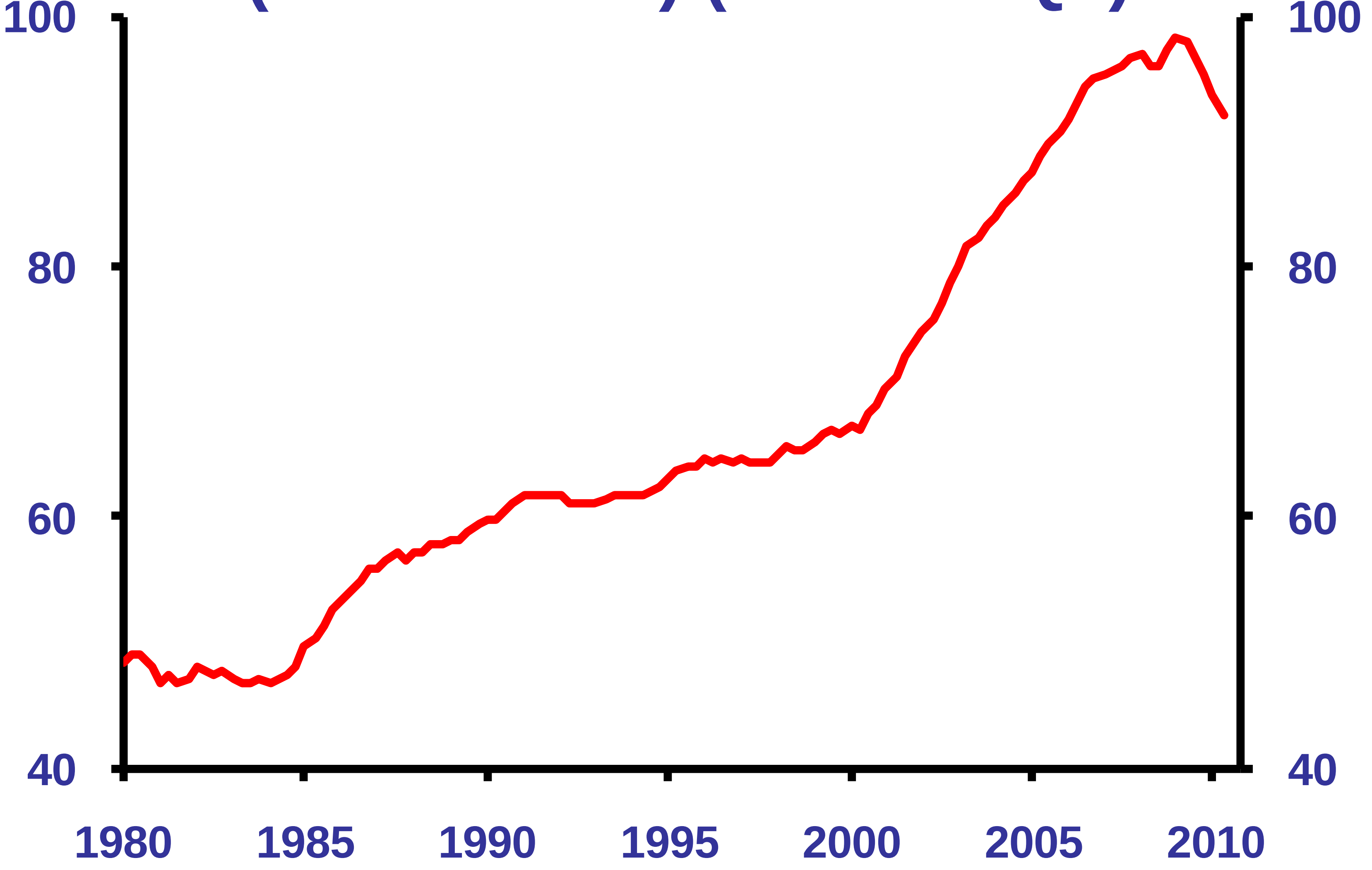
- **The oil producers – oil prices might fall.**
- **China and emerging Asia – trade surpluses are the route to growth.**
- **Germany and her close neighbours – surpluses are a sign of virtue: 'if only the rest of the world could be like us'.**
- **China and Germany are similar – 'Chermany' – a large trade surplus, an undervalued currency and weak consumption.**

6. Government Debt to GDP (%) (2009)



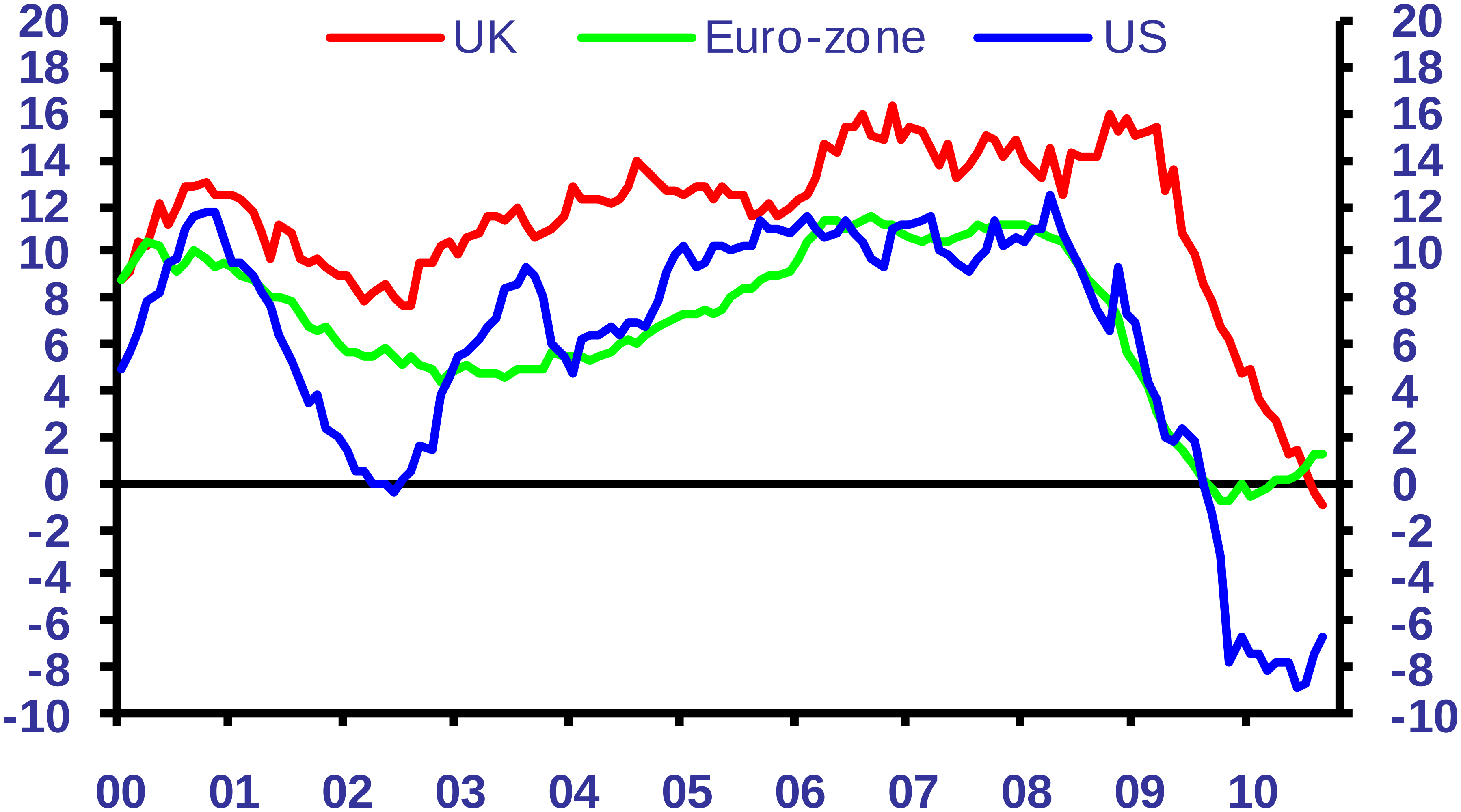
Source: OECD

7. US Household Debt (% of GDP) (1980 – 2010) (Latest = Q2)



Source: Thomson Datastream

8. Bank Lending (% y/y) (2000 - 2010) (Latest = August/September)

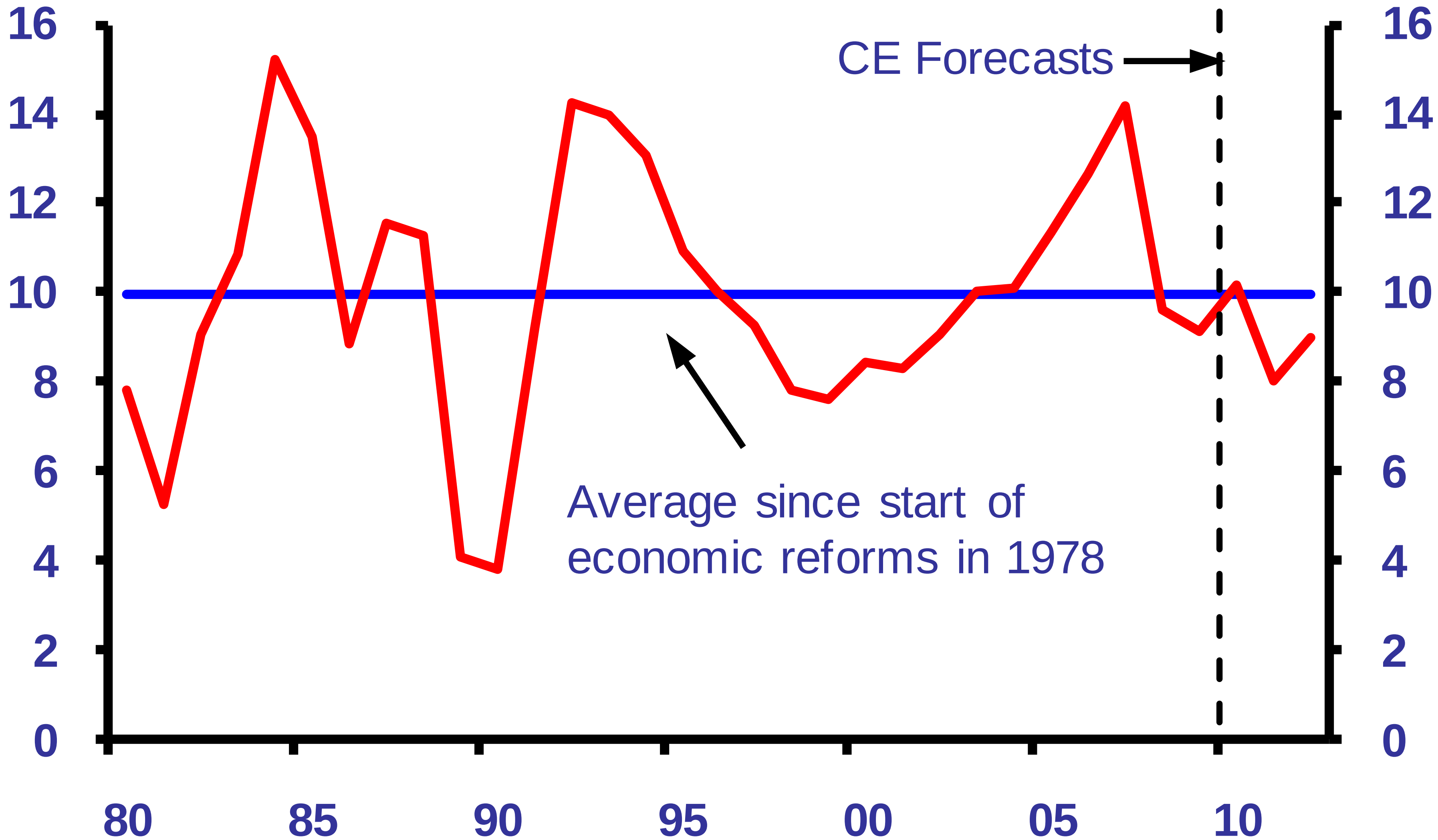


Source: Thomson Datastream

9. Capital Economics GDP Forecasts (% y/y) – Year Average

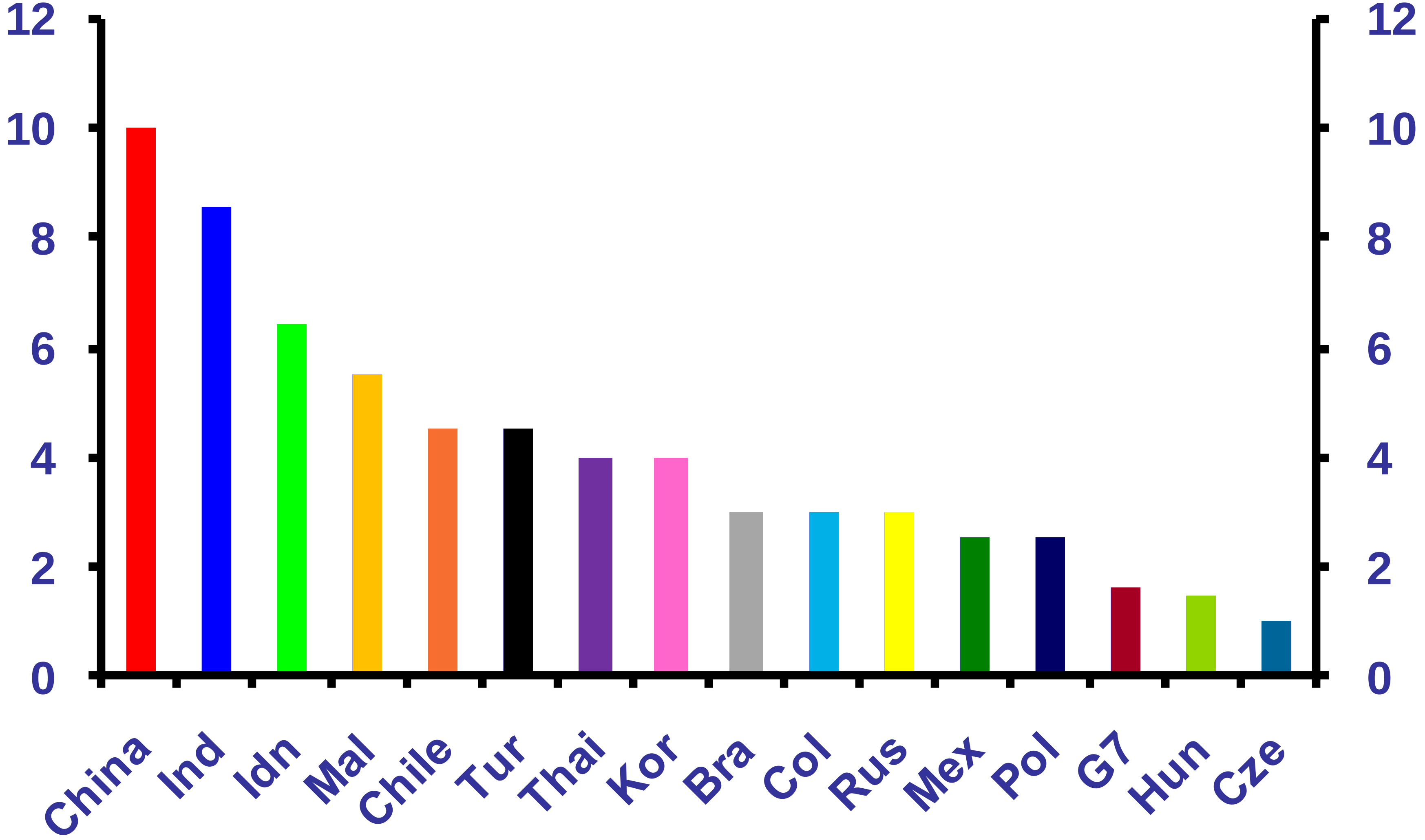
	2009	2010	2011	2012
US	-2.4	2.7	2.0	2.0
Canada	-2.5	3.0	2.0	2.5
Euro-zone	-4.1	1.5	0.5	1.0
UK	-4.9	1.7	1.0	1.5
Japan	-5.2	3.3	2.5	1.0
China	8.7	10.2	8.0	9.0

10. China GDP (% y/y)



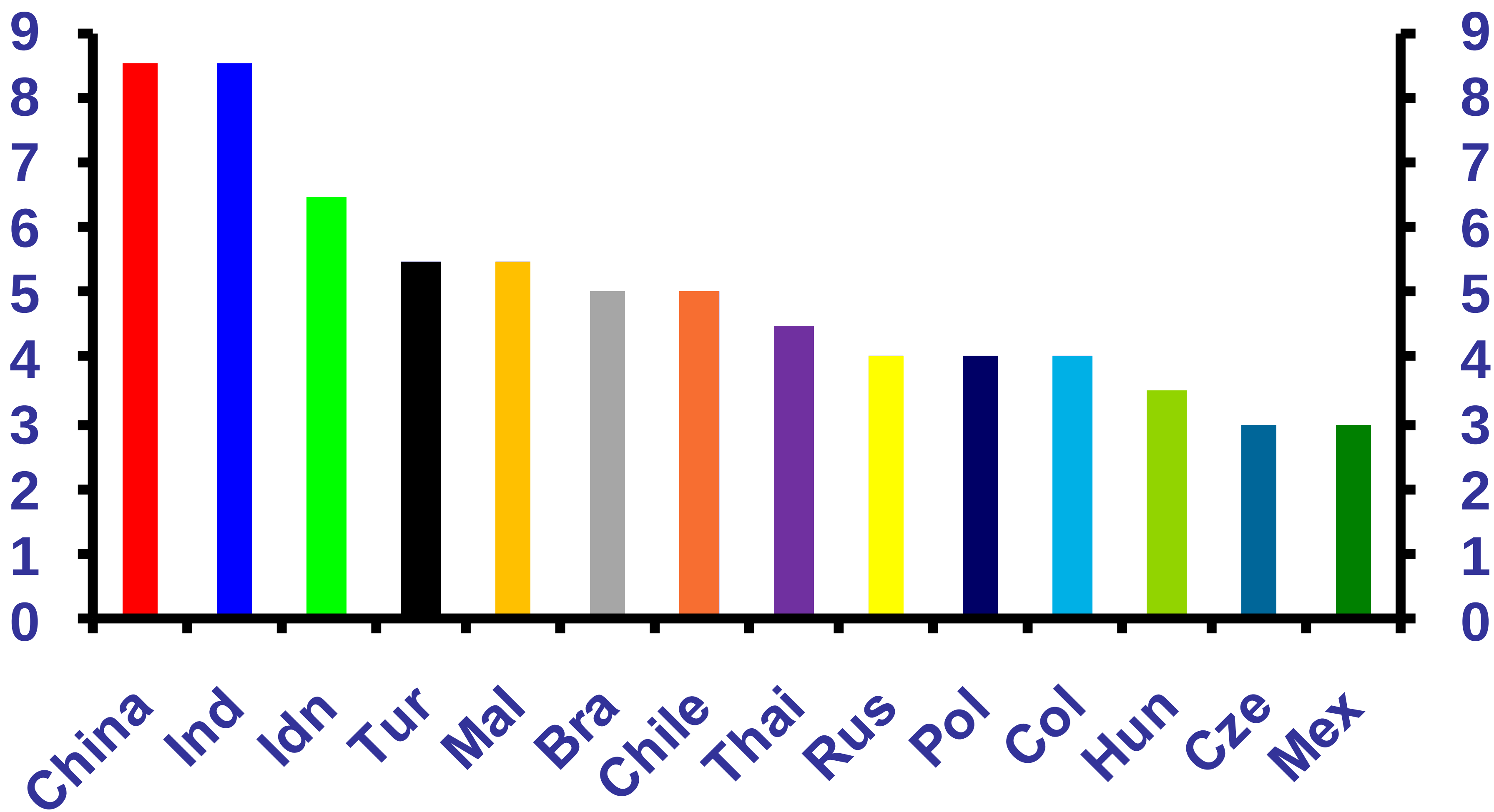
Source: CEIC, Capital Economics

11. Real GDP for the Emerging Markets (% y/y, 2011 forecast)



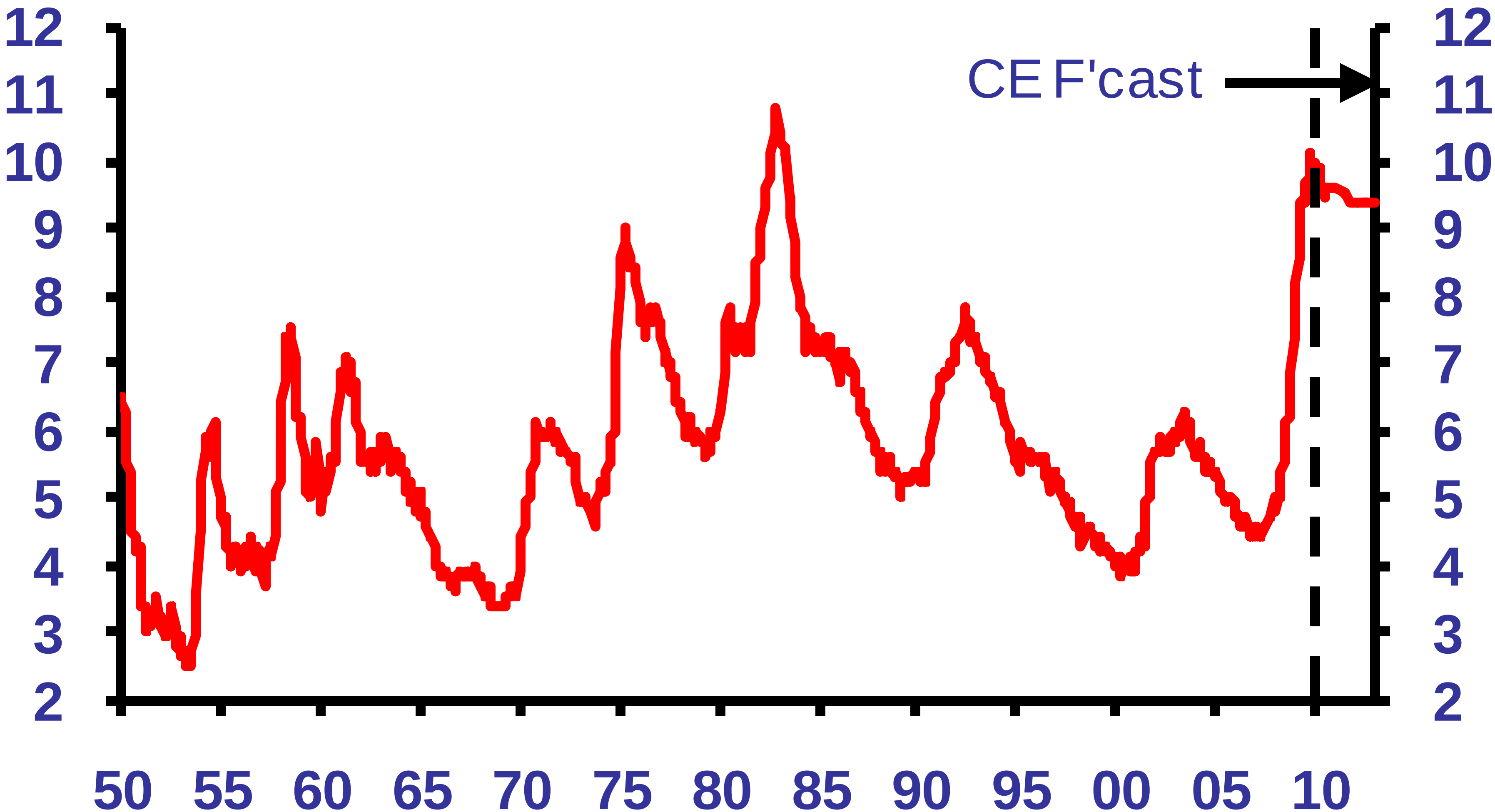
Source: Capital Economics

12. Potential GDP Growth in various Emerging Markets (% per annum over next fifteen years)



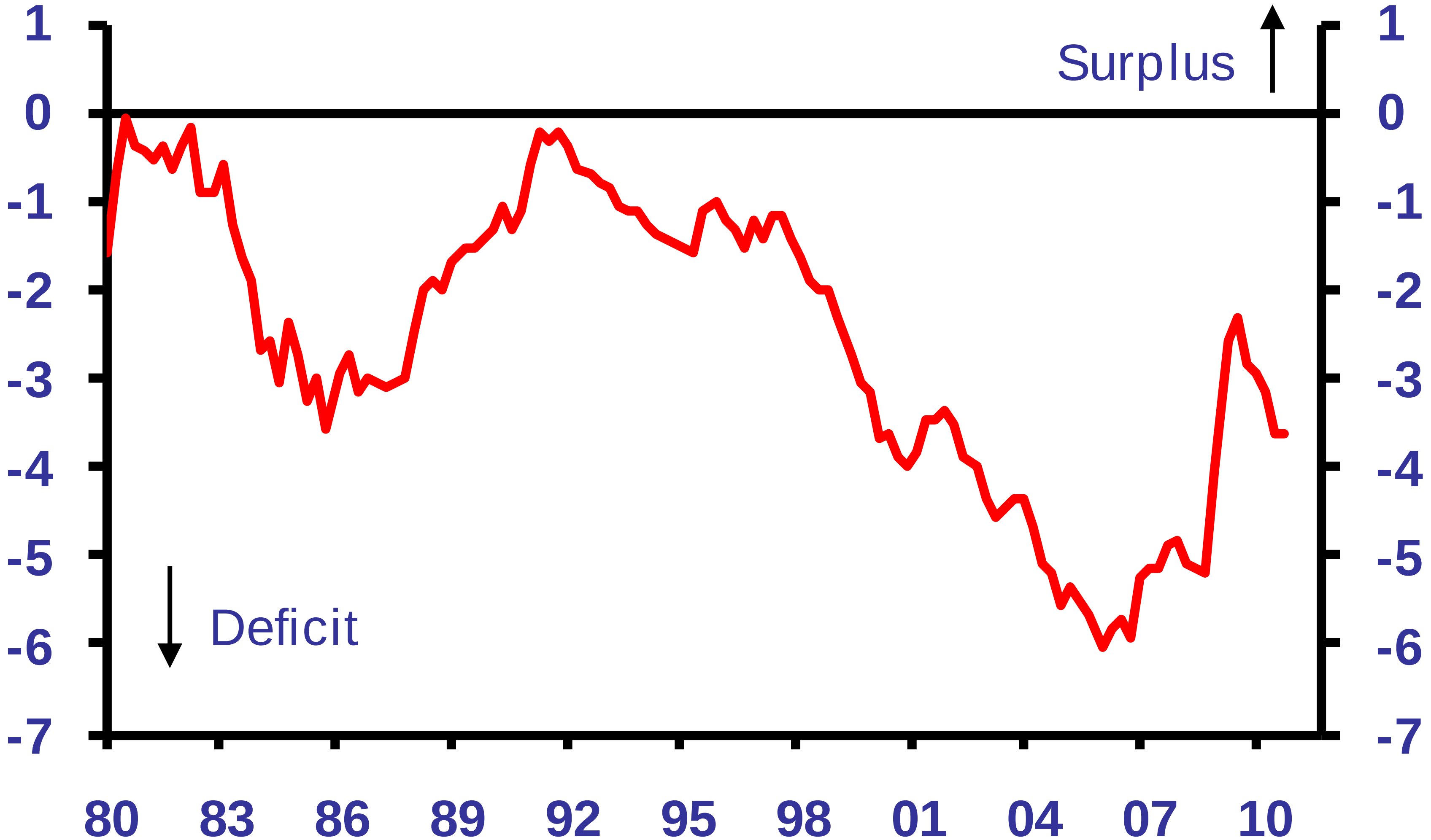
Source: Capital Economics

13. US Unemployment Rate (%) (1950 - 2012) (Latest = Oct.)



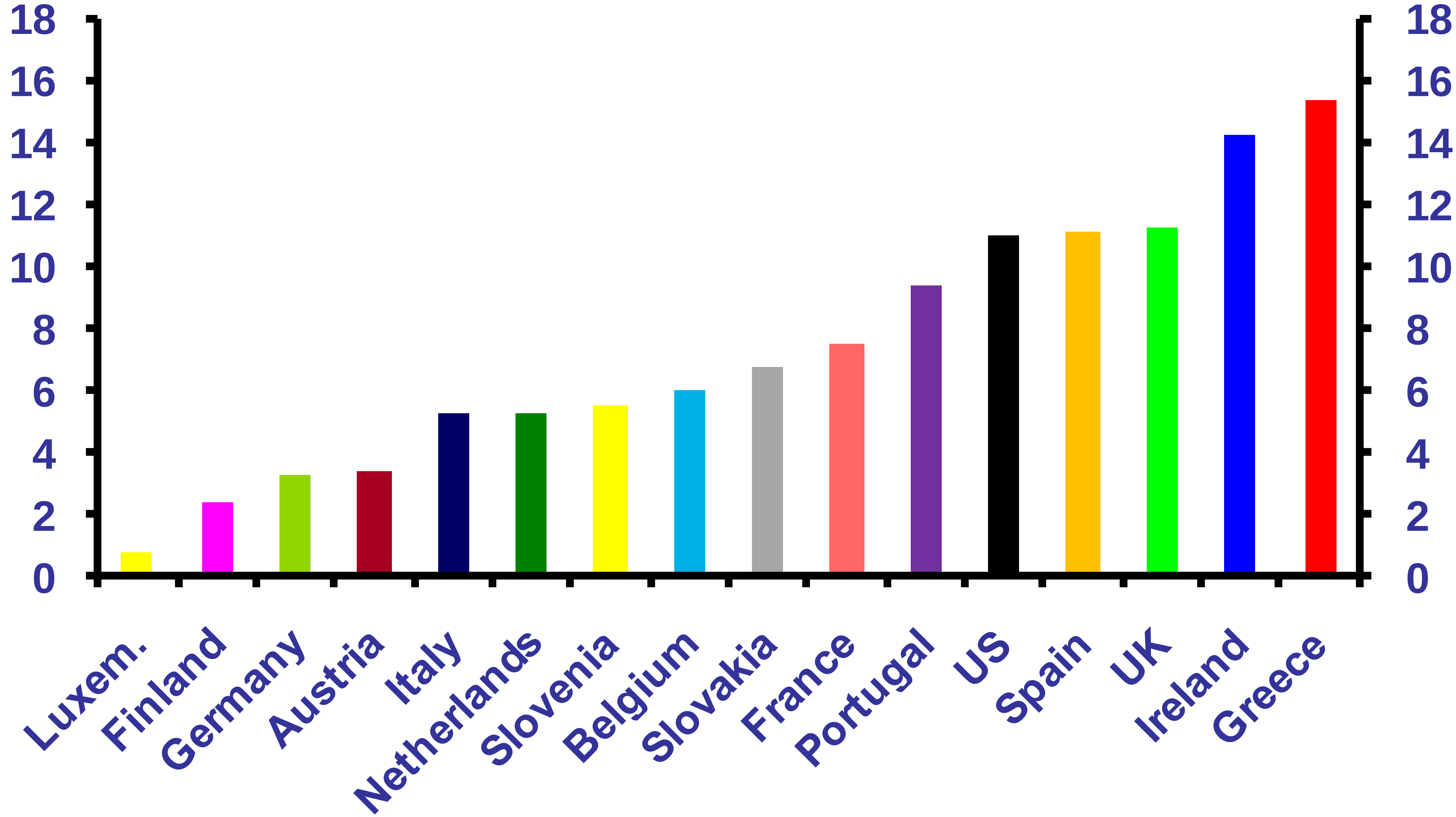
Source: Thomson Datastream, Capital Economics

14. US External Trade Balance (As a % of GDP) (1980 - 2010) (Latest = Q3)



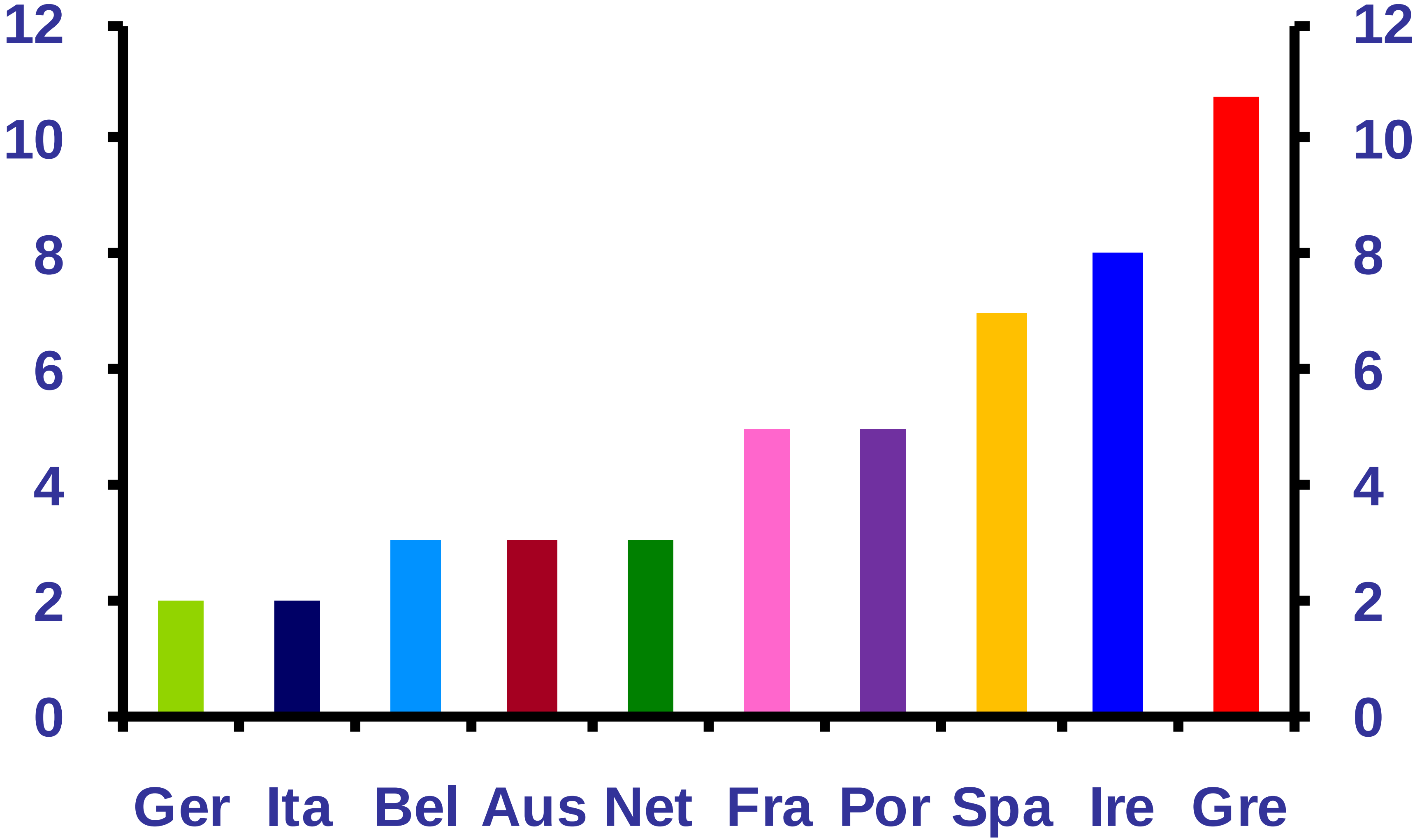
Source: Thomson Datastream

15. Government Deficit (% of GDP) (2009)



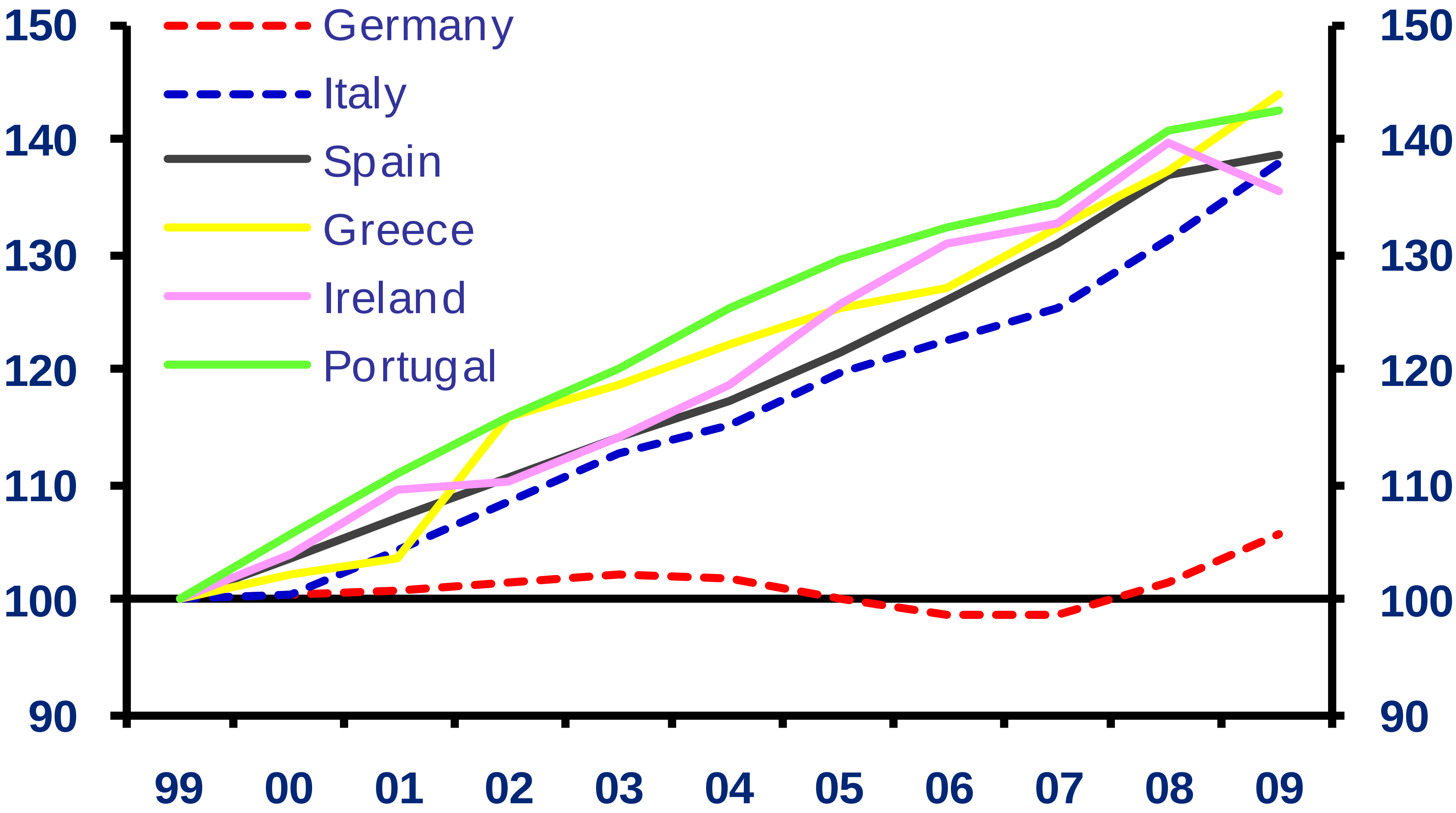
Source: OECD

16. EC's Required Fiscal Tightening (Cum. 2010 - 2013, as a % of Annual GDP)



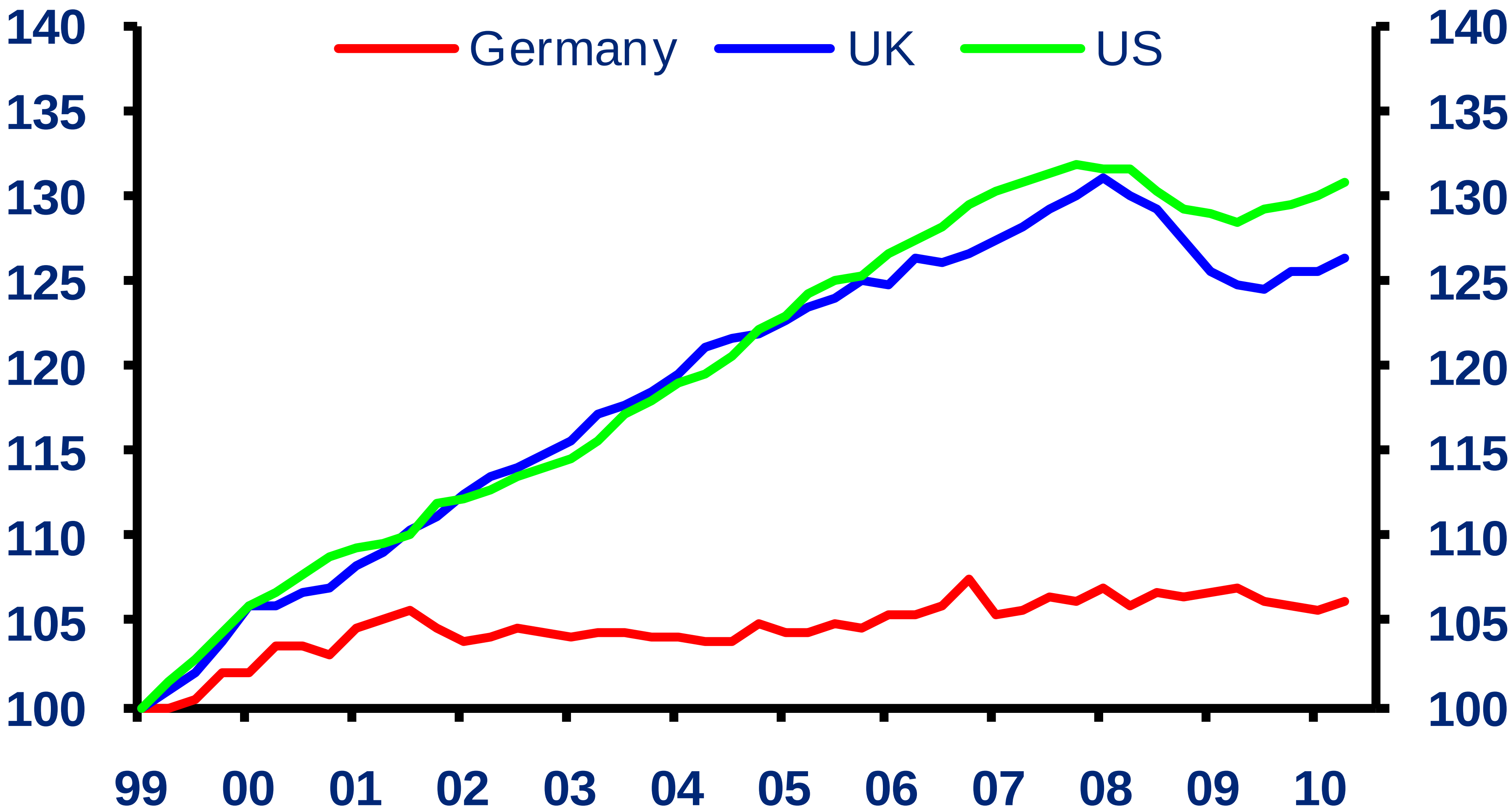
Source: European Commission

17. Unit Labour Costs (1999 = 100)



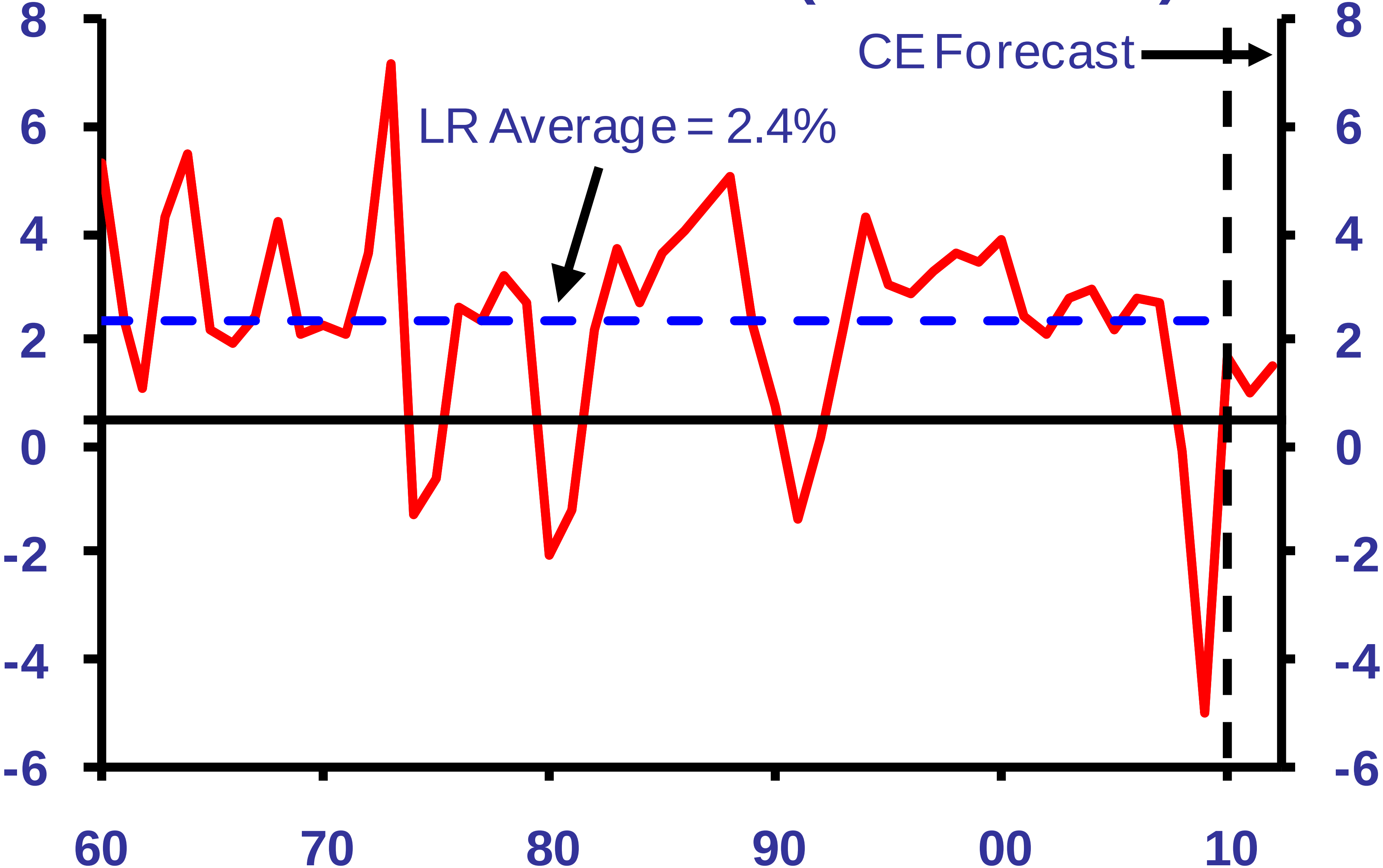
Source: ECB

18. Real Consumer Spending (1999 - 2010) (1999 = 100) (Latest = Q3)



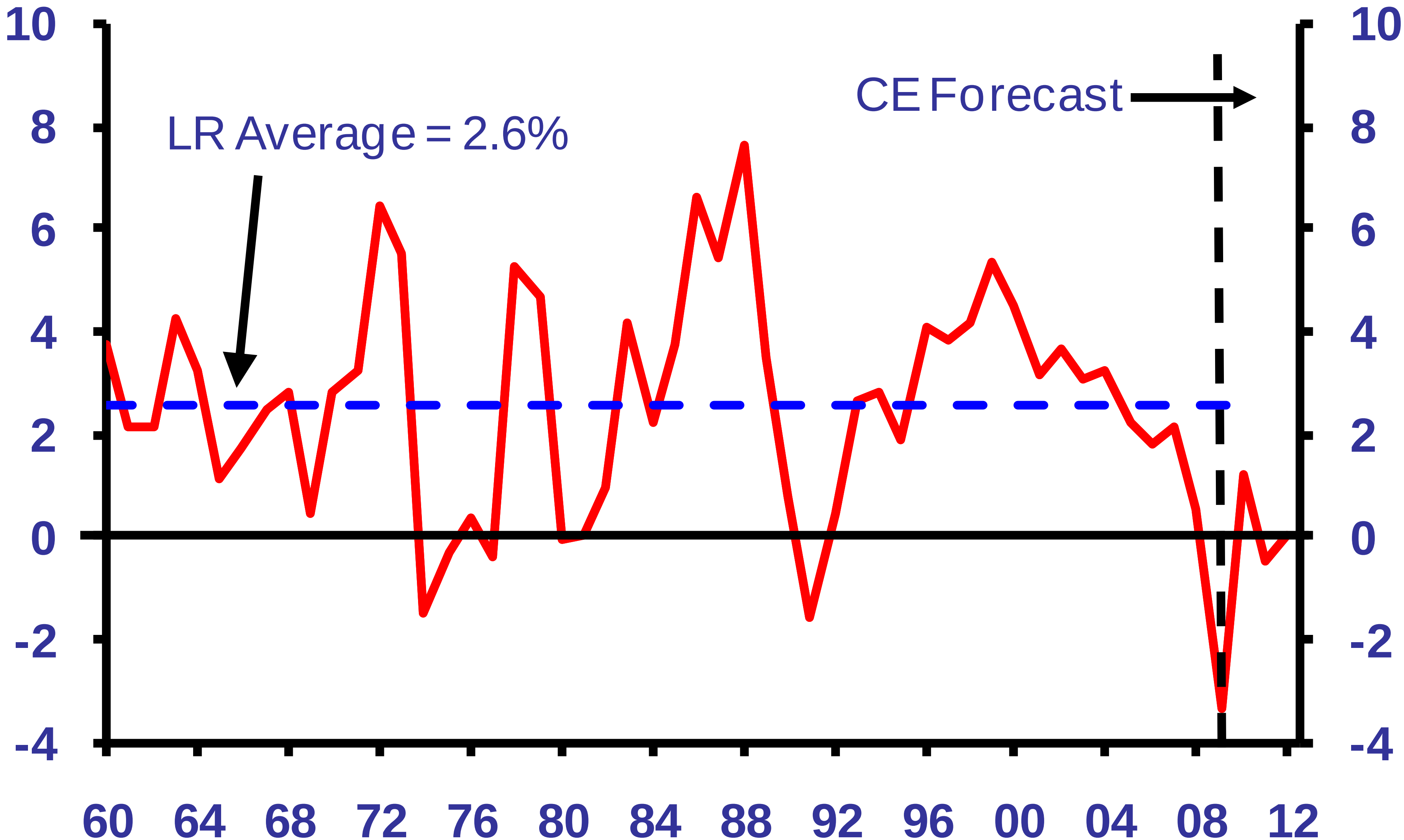
Source: Thomson Datastream

19. UK GDP Growth (1960 – 2012)



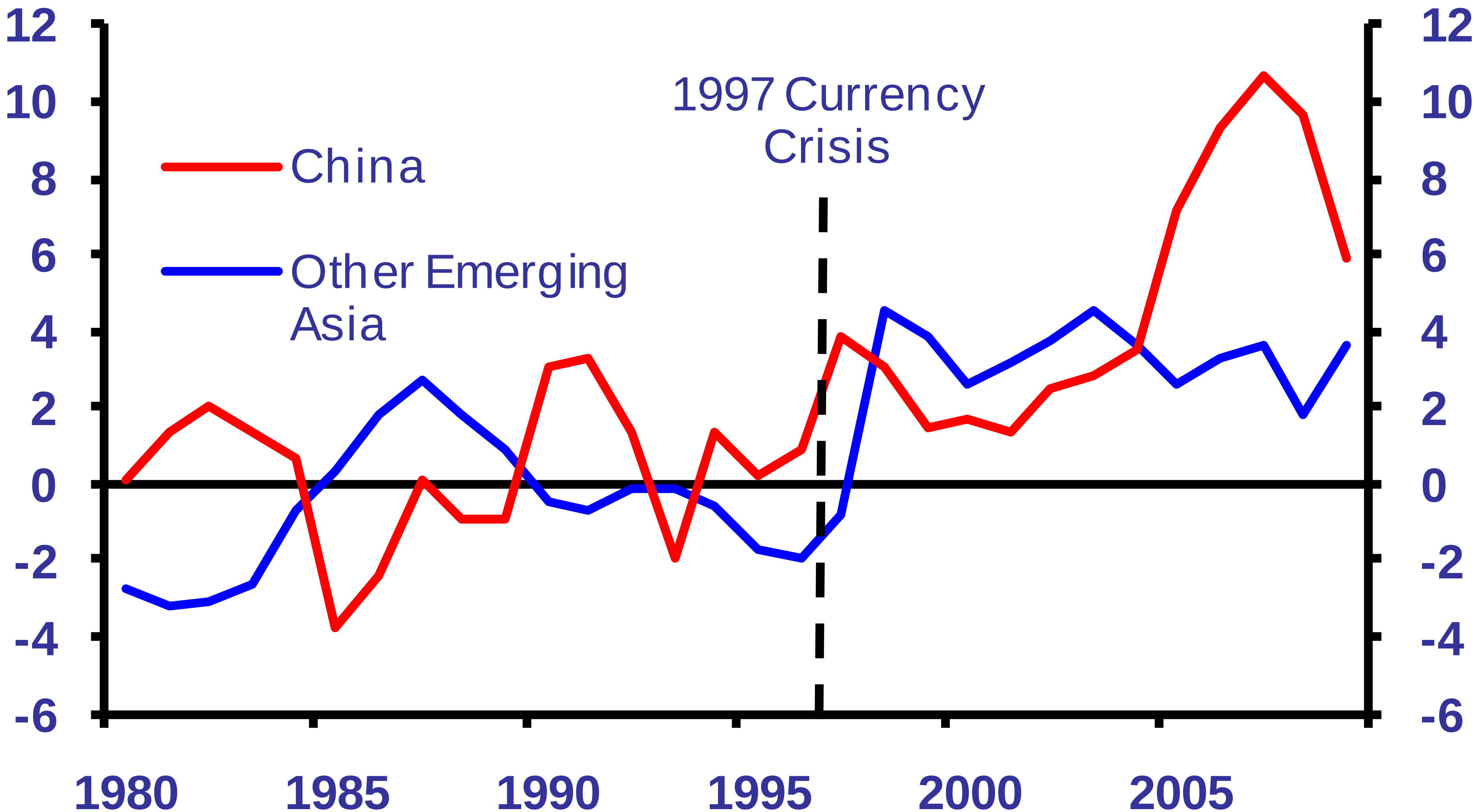
Source: Thomson Datastream, Capital Economics

20. UK Household Spending (% y/y) (1960 – 2012)



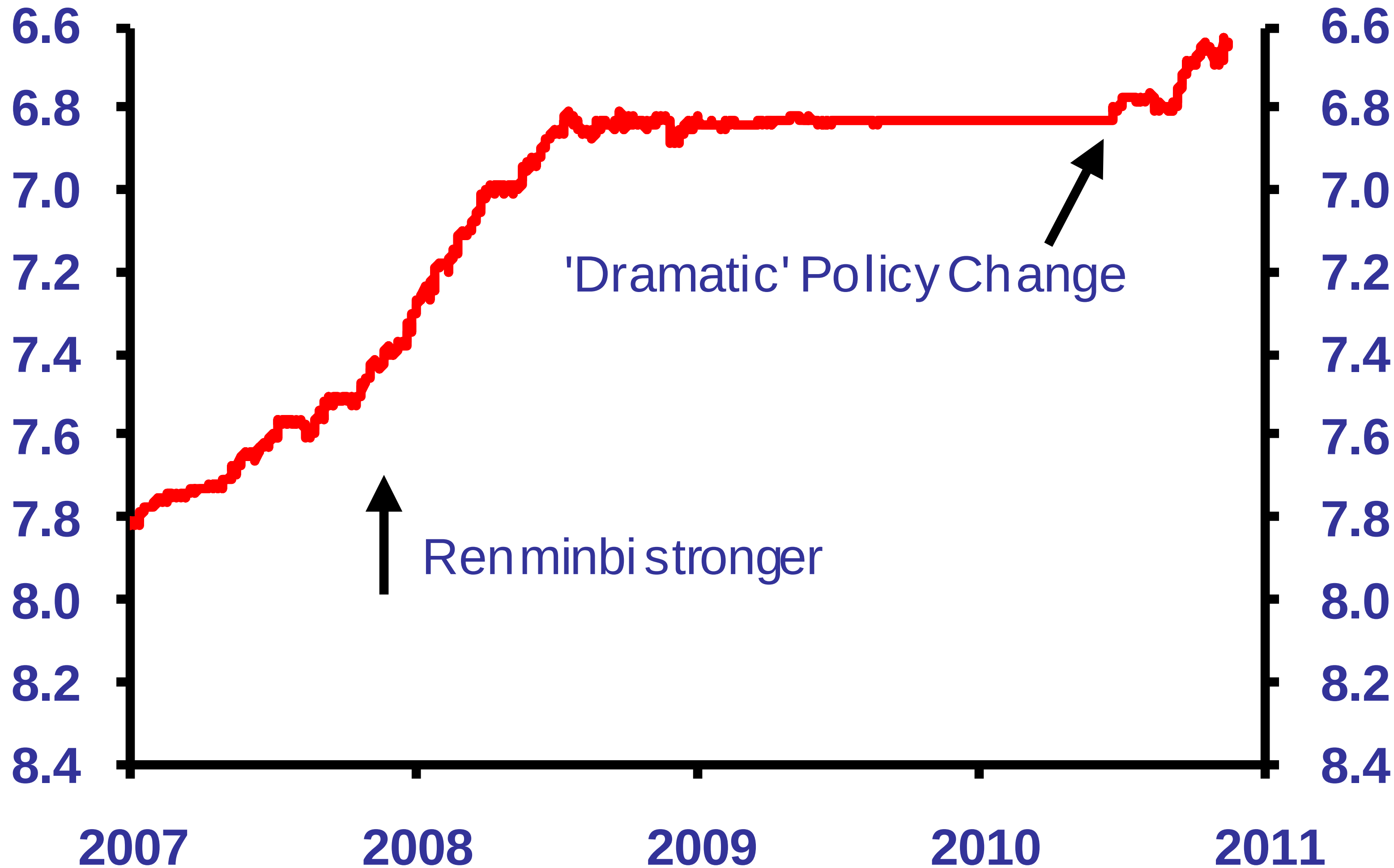
Source: Thomson Datastream, Capital Economics

21. Current Account Balances (as a % of GDP) (1980 -2009)



Sources: IMF

22. Renminbi/Dollar Exchange Rate (2007-2010) (Latest = 16th Nov.)



Source: Bloomberg

23. Difficulties with inflating away debt

1. Higher inflation raises tax revenues, but may raise government spending too.

2. Higher inflation is bad for *real* economic growth.

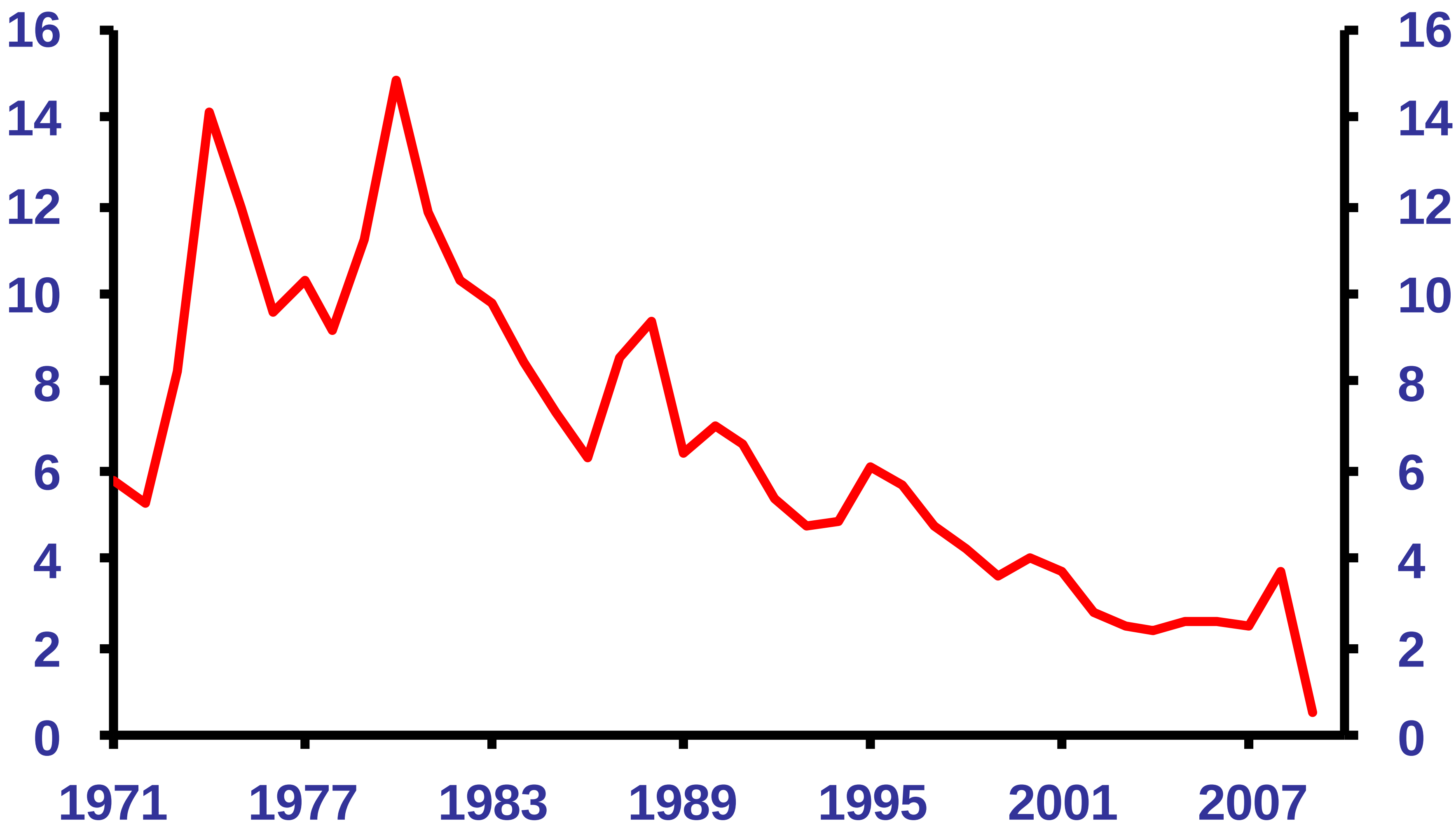
3. Inflation-linked debt increases in line with inflation.

4. Inflation raises the cost of new borrowing, making it more expensive to:

   - run a deficit.

   - roll over existing debt.

24. OECD CPI Inflation (% y/y) (1971 - 2009)

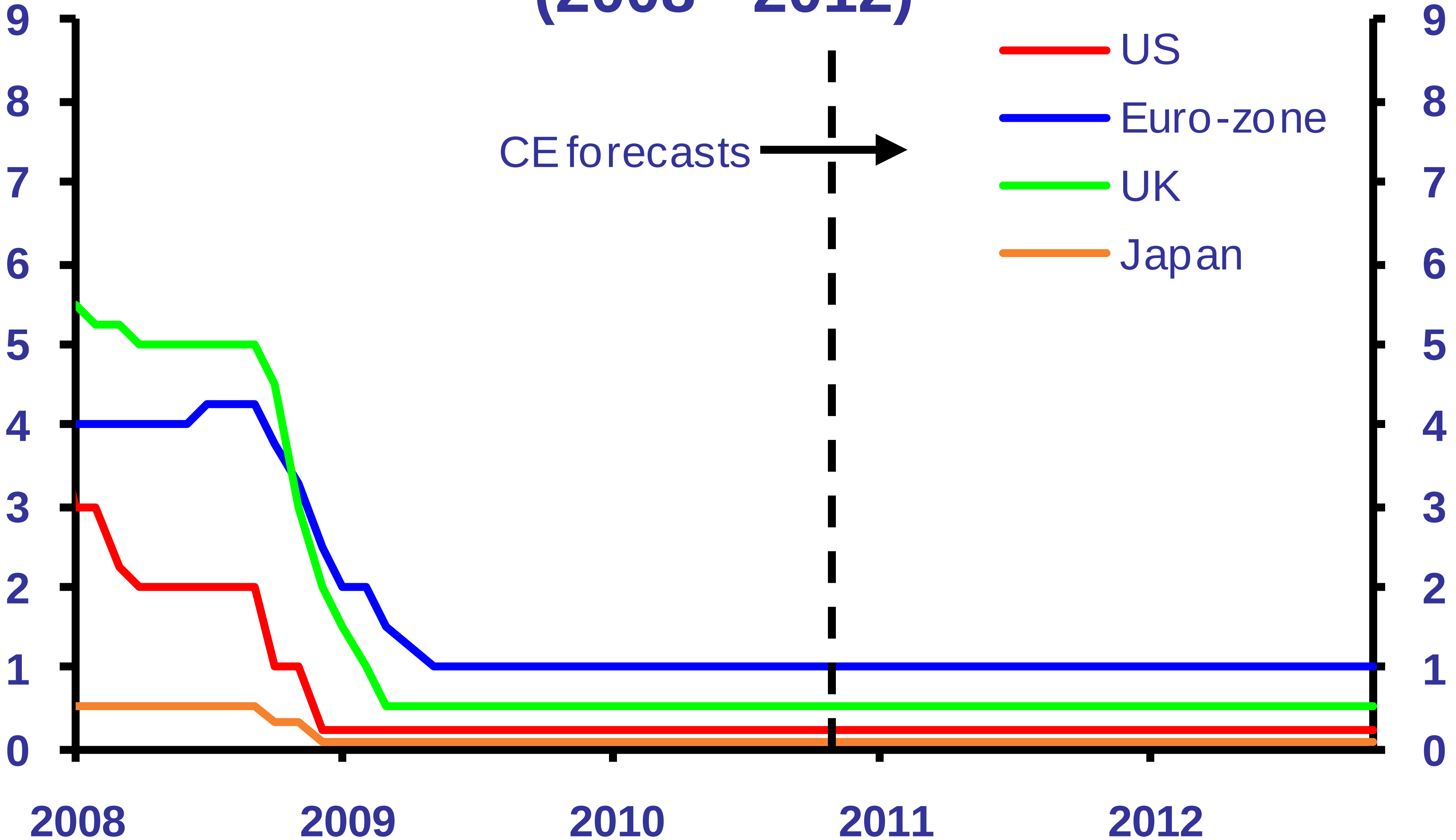


Source: Thomson Datastream

25. Capital Economics CPI Forecasts (% y/y) – Year Average

	2009	2010	2011	2012
US	-0.3	1.7	1.3	0.5
Canada	-0.5	1.5	1.0	1.0
Euro-zone	0.3	1.5	1.0	0.5
UK	2.2	3.2	2.5	1.0
Japan	-1.4	-0.5	-0.5	-0.5
China	-0.7	3.2	2.8	3.5

26. CE Interest Rate Expectations (%) (2008 - 2012)

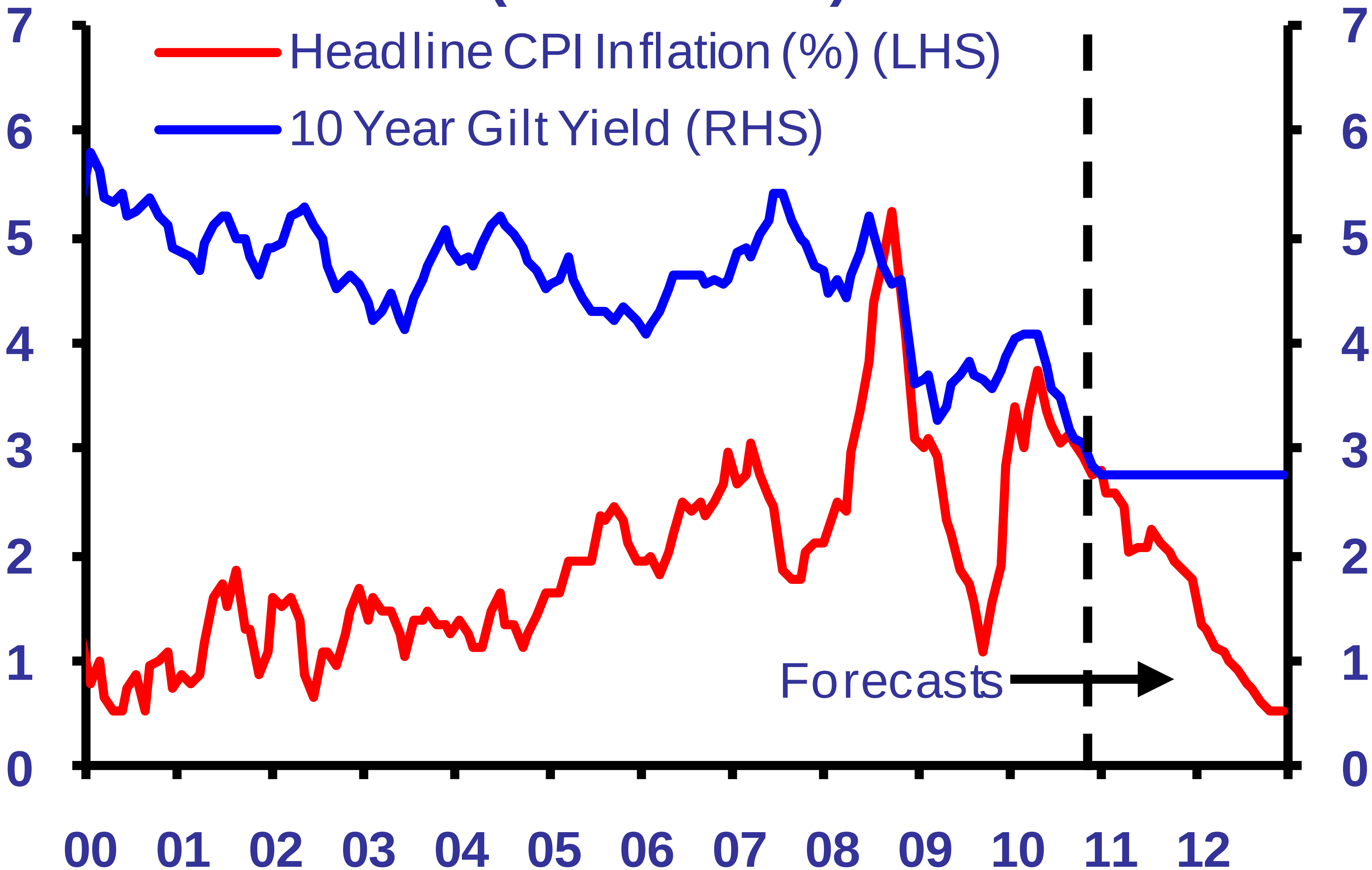


Sources: Bloomberg, Capital Economics

27. Capital Economics Key Market Forecasts

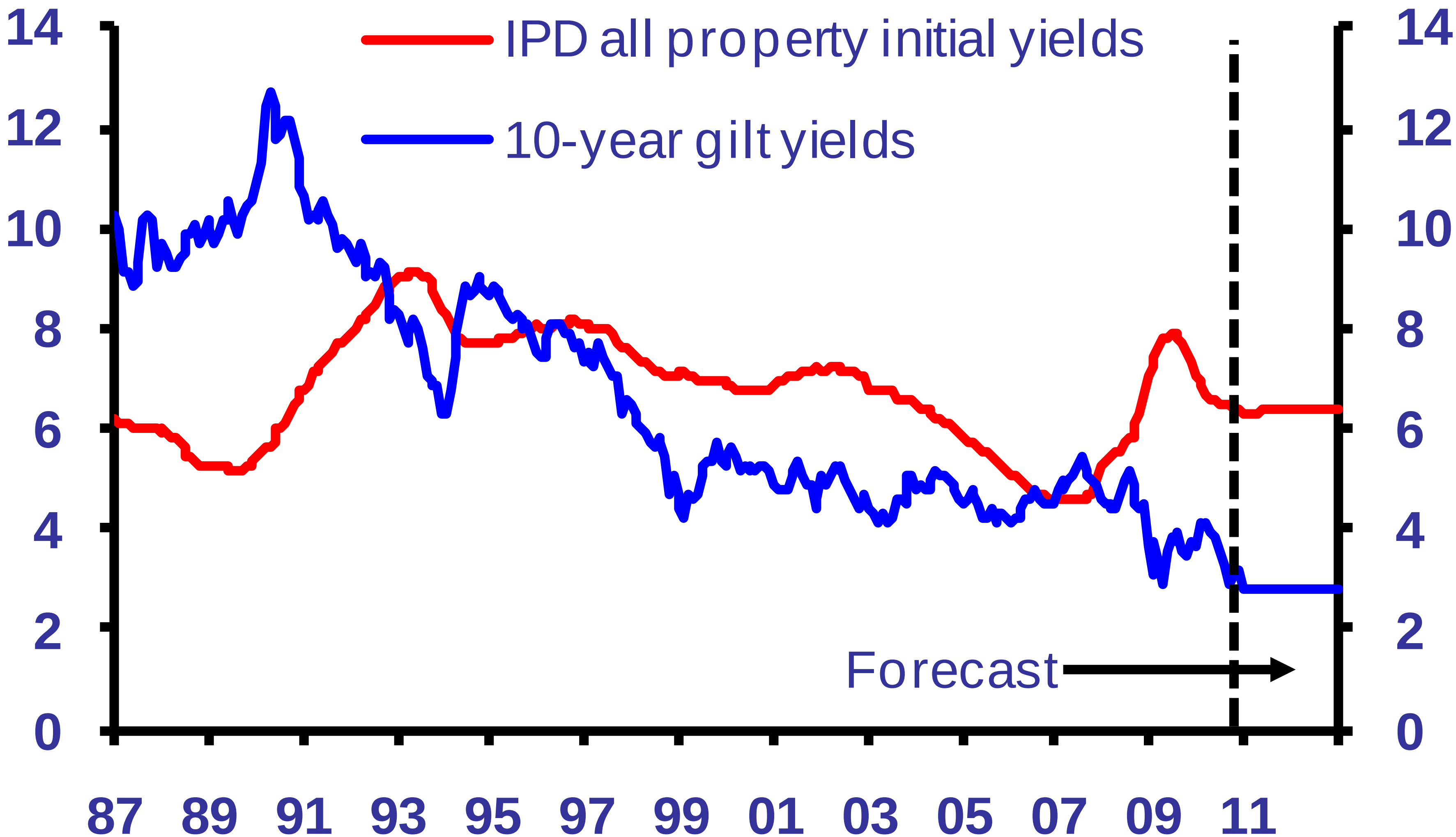
Year End	Now	2011f	2012f
US S&P 500	1200	1100	1100
US Treasury (10Y %)	2.90	2.50	2.50
UK Gilt (10Y %)	3.30	2.75	2.75
Dollar/Euro	1.35	1.00	1.00
Dollar/Sterling	1.60	1.40	1.40
Yen/Dollar	85	90	100
Oil (Brent $/pb)	80	60	60

28. UK 10-Year Gilt Yields and CPI Inflation (2000 – 2012)



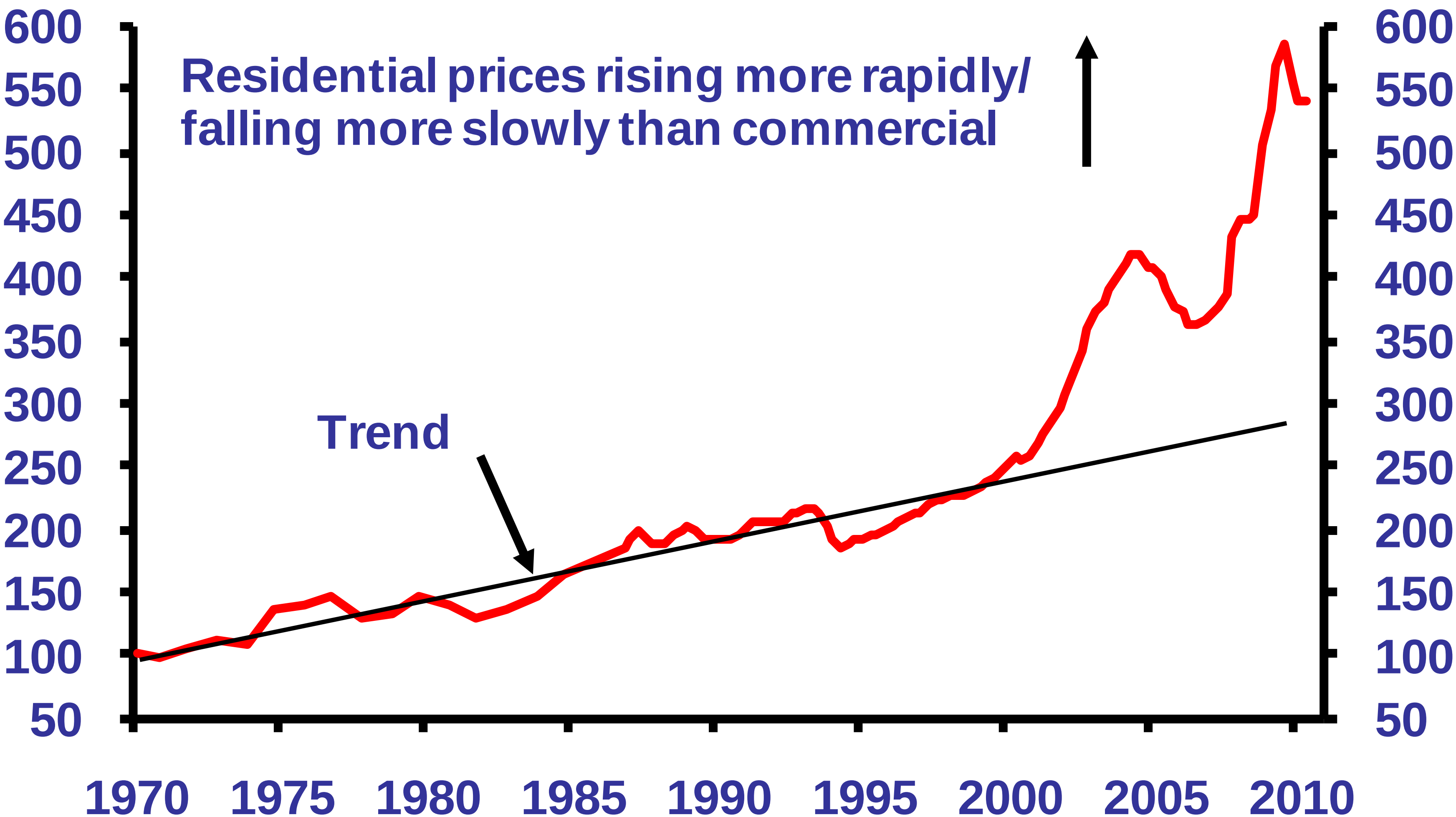
Sources: Thomson Datastream, Capital Economics

29. All-Property Initial Yields and 10-Year Government Bond Yields (%) (1989- 2012)



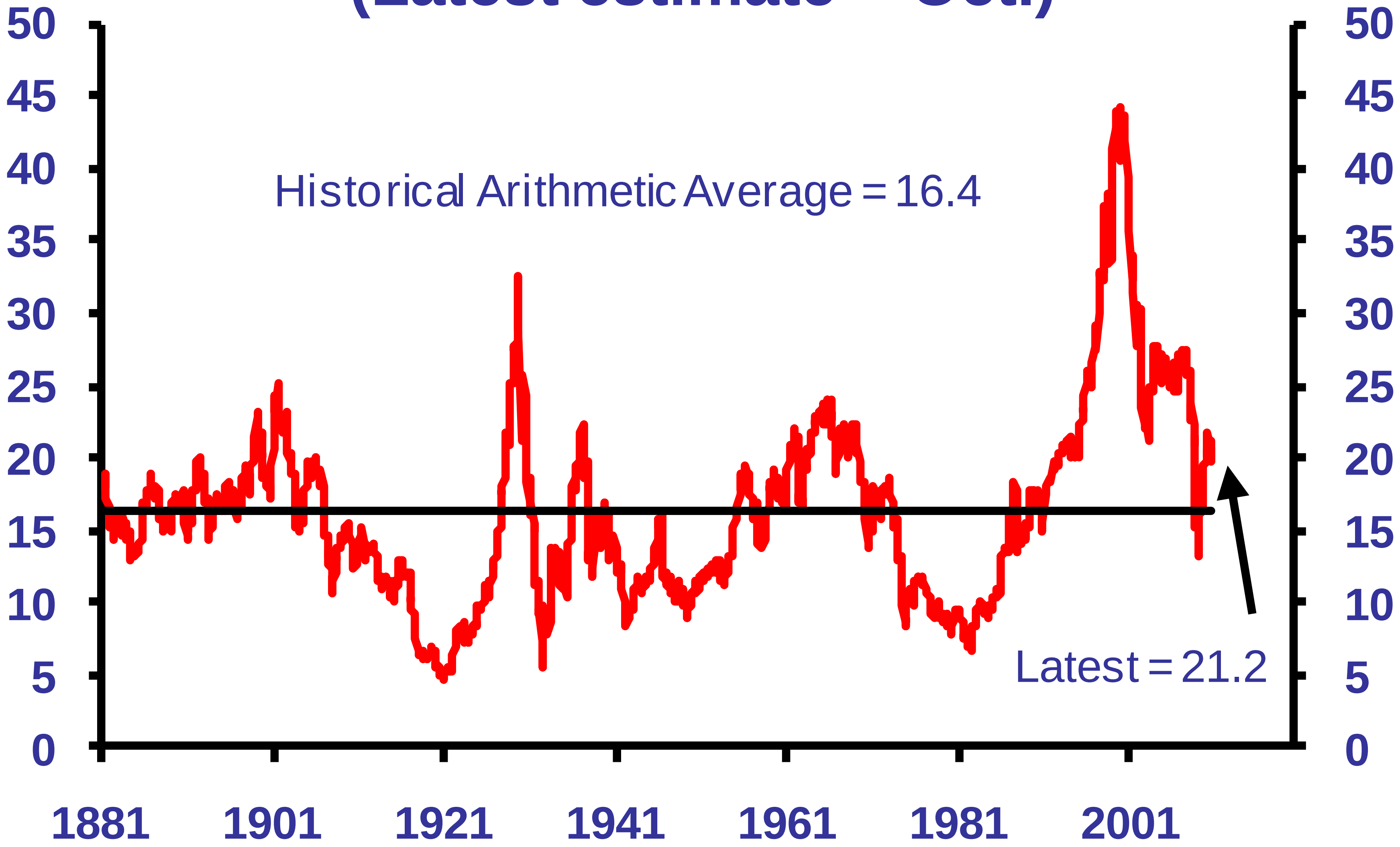
Sources: Thomson Datastream, IPD, Capital Economics

30. Ratio of Residential to Commercial Property Prices (1970 =100) (1970 – 2010)



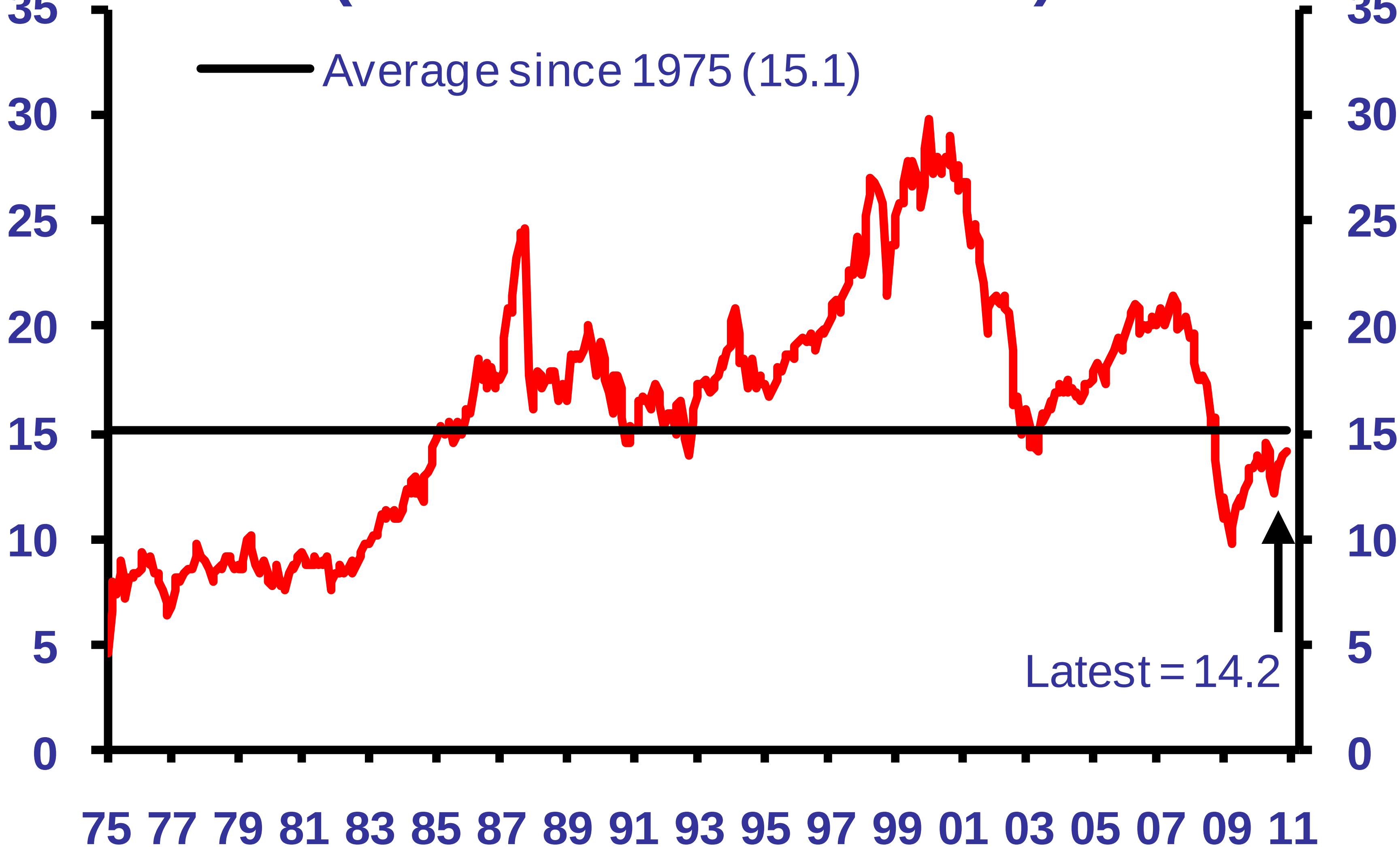
Sources: Thomson Datastream, IPD, Capital Economics

31. US Equity Market Valuation
(Latest estimate = Oct.)



Sources: Shiller, Wright, Thomson Datastream, Capital Economics

32. UK Equity Market Valuation (Latest estimate = Nov.)



Sources: Thomson Datastream, Capital Economics

33. The Central Scenario

- The world economy remains fragile.

- Growth will be strong in most of the emerging markets, especially China, but weak in the developed world.

- Interest rates will remain low for an extended period. European equities and commercial property to hold up well.

34. Major Risks

- A fall back to recession in the West.
- Inflation, theoretically, a big risk: but in practice, I think deflation is the greater danger.
- Trade protectionism could overwhelm the world economy – making it less globalised.
- Collapse of commodity prices.
- Severe weakness of house prices in the UK especially.
- Sovereign debt problems in the euro-zone cause a second financial crisis.

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