Economist Intelligence Unit

The Economist

The search for growth

Opportunities and risks for institutional investors in 2012

A report from the Economist Intelligence Unit

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Contents

About this report

The search for growth is the second annual report produced by the Economist Intelligence Unit, and sponsored by BNY Mellon. The research explores the global investment environment that is unfolding in 2012, and asks where investors are looking for growth opportunities in today's tepid market environment. The report is part of an annual series and builds on the findings of last year's survey and reports. The Economist Intelligence Unit bears sole responsibility for the content and the findings, and the views expressed do not necessarily reflect those of the sponsor. The report was written by Eric Laursen and edited by Annabel Symington.

The research is based on two main initiatives. In January 2012 the Economist Intelligence Unit conducted a survey of nearly 800 institutional investors and corporate executives. The respondents were drawn from 77 countries. To complement the survey results, the Economist Intelligence Unit carried out a series of in-depth interviews with leading global pension sponsors, non-profit portfolio managers, economists and private equity and hedge fund managers. The insights from many of these interviews appear throughout the report. While not everyone interviewed is quoted in the report, the Economist Intelligence Unit would like to thank everyone for their valuable contribution.

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- Prasant Bhansaali, director, Mehta Equities Ltd, India
- Brad Cann, SVP-business development, Horizons Exchange Traded Funds, Canada
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Executive summary

Positive forces could take hold, bringing more opportunities than investors dare hope for today.

Global investors surveyed in January expressed tempered optimism about growth prospects over the next 12 months. Some stabilisation of the European debt markets following the European Central Bank's (ECB) provision of cheap loans to the banks is buying time for EU member states to engineer an economic recovery, while signs of a modest improvement in the US and the relative resilience of emerging markets to a global slowdown provide further support to investor sentiment.

Opinions among survey respondents and interviewees vary widely according to region—unsurprisingly given the dramatically different growth prospects of emerging Asian and euro zone countries. Most investors agree in their overall assessment. However, geopolitical concerns will evolve over the course of the year, and likewise, positive forces could take hold, bringing more opportunities than investors dare hope for today.

The search for growth is the second annual report produced by the Economist Intelligence Unit, and sponsored by BNY Mellon. The research aims to paint a picture of the global economy and the investment market in 2012, and to explore where investors are looking for growth opportunities in today's tepid market environment. The report is part of an annual series and builds on the findings of last year's survey and reports.

Notable conclusions from the research include:

- **Investors see some opportunities in global financial markets.** Among survey respondents, 85% perceive significant opportunities, although 51% acknowledge that there are major downside risks. Some easing of the European debt crisis, coupled with a somewhat better economic performance in the US, has created a more stable outlook for financial markets.

- **Geopolitics rather than market forces will govern the outcome in 2012.** Hopes for further improvement hinge less on economic activity generated by the private sector than on governments' ability to play their geopolitical roles properly. The threat of an oil price spike, tied in part to tensions over Iran's nuclear programme, is the main risk to the global recovery. However, recent events in Spain may see the future of the single currency union retake the top spot.

- **High levels of debt continue to be a major concern.** Over the next 12 months debt levels are unlikely to change, but debt continues to restrict the world economy's recovery from the 2008 global economic crisis.

- **Low levels of capital investment temper opportunities**. Less than half (45%) of respondents think that businesses will increase capital investment in 2012. Respondents from the US, where the economy is slowly improving, appear slightly more optimistic.

- **The US finds favour as stable middle ground**. With GDP forecast to grow modestly, investors now see the US as offering an attractive risk/reward trade-off. In this year's survey the US moves from fourth to third place for asset price growth, with 40% of respondents placing it among their top three markets.

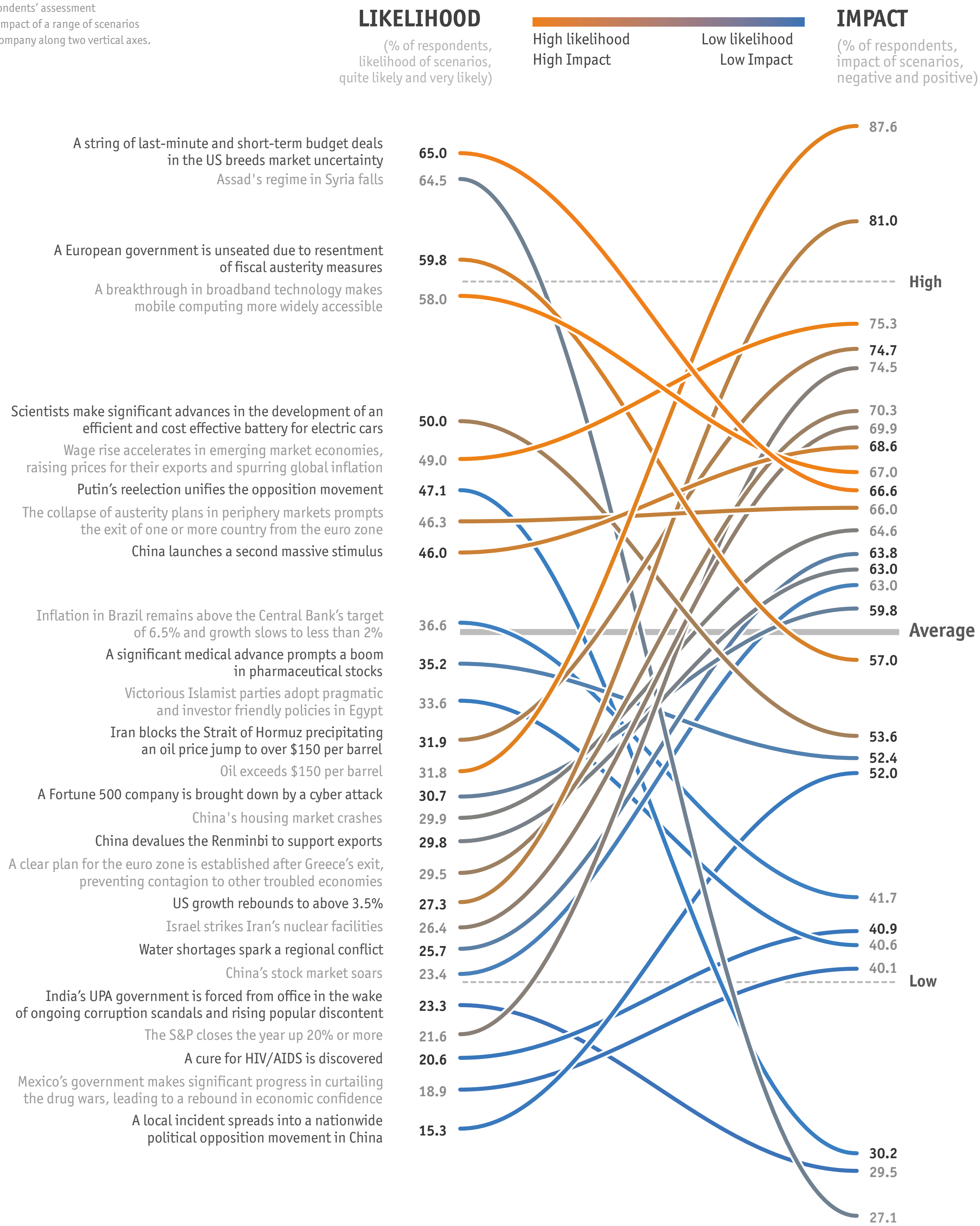
- **Slower growth in China and India shifts attention to smaller emerging economies**. Smaller economies are likely to benefit from demographic trends—such as relatively young populations—as well as economic or political factors such as low wage costs, low public and private debt levels, rising domestic consumption and deepening financial markets. South-east Asia, in particular, is attracting investor attention, replacing Brazil in fifth position among markets offering the best opportunities for asset price growth this year.

- **European investors are more optimistic than the global aggregate about the euro zone's future**. Almost half (47%) of survey respondents agree that an austerity plan is likely to collapse in one or more peripheral euro zone countries, prompting the exit of one or more in the next 12 months. But less than one-third (29%) of European investors think this scenario is likely.

- **Investors move away from commodities**. Lower demand for many raw materials from sluggish developed markets in the euro zone and elsewhere is pushing investors away from commodities. Another reason, according to some investors, may be a desire by large institutions to concentrate on highly liquid assets during a time of uncertainty. ■

Scenario analysis

This chart shows respondents' assessment of the likelihood and impact of a range of scenarios on their portfolio or company along two vertical axes.



Source: Economist Intelligence Unit Survey, January 2012

Introduction

Are investors pinning too much hope on what appears to be just a slight respite in financial markets?

Global investors have replaced the bullish outlook many expressed in early 2011 with a more tempered optimism. Global economic prospects continue to improve, thanks to aggressive action by the European Central Bank (ECB), which has partially stabilised the euro zone. This has also reduced pressures in the US, and latest economic data suggests a glimmer of hope. However, significant risks continue to be posed by the euro zone's peripheral markets, and following a series of missteps by the Spanish government the euro zone crisis is threatening to return to the fore.

Yet the fundamentals of the global economy have not improved significantly, and new risks have arisen to replace older ones. The recent rise in the price of crude oil, tied in part to tensions over Iran's nuclear programme, has emerged as the main obstacle to global growth—at least for the moment. Even in the absence of military action, this is already creating headwinds for oil-dependent economies, particularly the US.

The optimism displayed in this year's survey of global institutional investors may be explained by timing: the survey was conducted during the stockmarket rally that opened 2012. At this point, much of the positive economic news may already be priced into the market, and downside risks remain very large. This raises the question: are investors pinning too much hope on what appears to be just a respite in financial markets?

Responses from the survey indicate that investors believe the principal risks the market will face in 2012 relate to geopolitical events rather than strictly market-based developments. They also suggest that some positive surprises may be hovering in the wings: over half (58%) of respondents say that a breakthrough in broadband technology that makes mobile computing more widely accessible is likely, and 66% say that this would have a positive impact on their portfolio. However, there is undoubtedly a recognition that the fragile post-2008 economy will linger for some time.

This report is based on the second annual *Search for growth* survey of nearly 800 leading global pension sponsors, non-profit portfolio managers, economists, private equity and hedge fund managers and corporate executives as well as a series of one-on-one interviews. The research, sponsored by BNY Mellon, aims to provide an overview of the global economy and investment market that is unfolding in 2012, and to explore where investors are looking for growth opportunities in today's tepid market environment. ■

1 Global economic outlook: Tempered optimism after a roller-coaster year

Investors interviewed for this report repeatedly expressed concern about the debt burden of households, governments and companies.

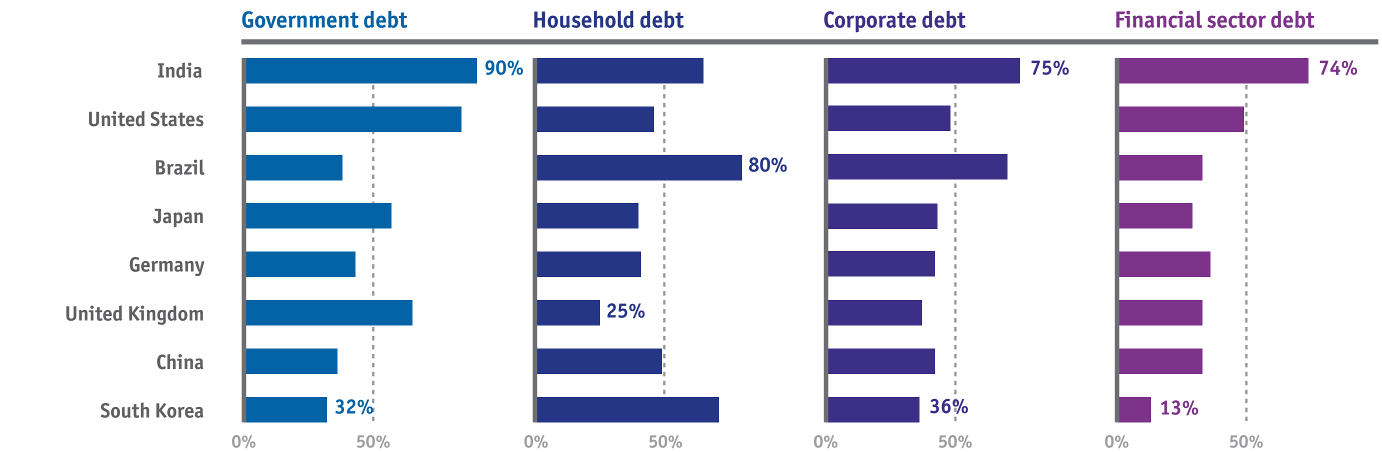
The threat to the global economy posed by the euro zone has moved from acute to chronic, and other economic signposts are pointing in a more positive direction. Growth in the US, although tepid by historical standards, is firming, and the possibility of a recession has all but disappeared. China looks headed for a soft landing, with a respectable growth forecast of 8.3% in 2012, according to the Economist Intelligence Unit. None of these improvements suggests that the global economy will perform at anything approaching a robust level over the next year, but a financial and economic implosion—of the kind triggered by the bankruptcy of Lehman Brothers, a US investment bank, in late 2008—is less likely than it was at the start of 2012.

High levels of debt—both household borrowing and sovereign debt—continue to be a matter of concern. Investors interviewed for this report repeatedly expressed concern about the debt burden of households, governments and companies—particularly banks—which is a fundamental reason for the global economy's sluggish recovery from the 2008 global economic crisis. Survey respondents do not expect major progress on this front in the next 12 months: 47% anticipate an increase in household debt in their domestic economy, virtually unchanged from 2011; 48% expect higher corporate debt, down from 58% last year; and 63% predict a rise in government debt, compared with 71% in 2011. However, assessments range widely from country to country. US-based respondents are most concerned about the level of government debt, with 84% expecting it to rise this year. While this is in part attributable to the failure of the US Congress joint select committee on deficit reduction, the so-called super committee, to reach a debt deal in November 2011, the greatest challenge facing the US government is soaring healthcare costs, although the pain from this will not be felt in the next 12 months. Overall, Asia-based respondents appear confident that they will see no surge in debt levels this year. Asia's strong economic fundamentals support this assessment: both government debt and private debt are generally low compared with the West. India is the exception in this group: 84% of India-based respondents are concerned that the level of government debt will rise rapidly this year. The reason for this is probably concern about the structural disarray of India's public finances, which are characterised by large structural deficits and high public debt, as well as worry about corruption. In addition to concern about government debt, over one-third of India-based respondents agree that the current United Progressive Alliance (UPA) government is likely to be forced from office this year in the wake of ongoing corruption scandals. Respondents are evenly split as to whether the impact of this would be positive or negative.

Investors are also concerned about low levels of capital investment. Only 42% of respondents think that businesses will increase capital investment in the next 12 months. The only sizable markets in which more than one-third of respondents expect

Q Over the next twelve months, do you expect debt ratios across the following categories to increase in your domestic market?

(% of respondents)



Countries ranked from most to least projected debt

High and low figures in each category indicated

Source: Economist Intelligence Unit survey, January 2012

to see more capital spending are China and India (both 36%); Brazil (43%); the US, where the economy is improving slowly (62%); Japan, which is rebuilding following the natural catastrophes of 2011 (40%); and Australia, which is benefiting from China's appetite for its natural resources (39%).

Hopes for further improvement hinge less on economic activity generated by the private sector than on governments' ability to play their geopolitical roles properly—avoiding a Middle East crisis that could cause oil prices to spike being a critical example. While investors are roughly split on whether tensions in the Middle East will escalate this year, they are nearly unanimous about the extent of the impact it would have on their portfolios: 68% say that they would be negatively impacted if Iran blocked the Strait of Hormuz, precipitating an oil price jump to over US$150/ barrel, and 71% say the same of an Israeli-led strike on Iran's nuclear facilities. Engineering a lowering of public debt in overleveraged developed countries is perceived as another key threat to the global economy. Among developed economies, while the outlook in the US is better than last year, "in Europe, there's not much reason for corporations to be investing significantly until the economy is doing better," says Esteban Jadresic, chief economist and global investment strategist at Moneda Asset Management, Chile.

> "In Europe, there's not much reason for corporations to be investing significantly until the economy is doing better."
>
> Esteban Jadresic, chief economist and global investment strategist, Moneda Asset Management, Chile

That said, some respite has been provided by the Greek debt restructuring and the provision by the ECB of cheap finance beginning in the fourth quarter of 2011 to aid financial institutions. Somewhat better economic data in the US and the build-up of cash on large corporate balance sheets have also reassured global investors that the financial markets are sufficiently more stable than they were in the middle of last year to warrant dipping into once again. Among survey respondents, 85% perceive significant opportunities, compared with 86% in 2011. Of that group, 34% say they intend to take advantage of those opportunities in the next 12 months, up from 28% last year, while the proportion who say their concerns about downside risks will keep them from doing so has dropped to 51%, from 58% last year. It must again be noted, however, that investor sentiment may owe more to the stockmarket rally that was under way when the survey was in the field than to any suggestion that the fundamentals of the global economy have improved. ■

2 The European dilemma

More than 60% expect the euro to decrease in value-the worst projected performance for any currency covered in the survey.

Not only was 2011 a tumultuous year for Europe—and specifically the euro zone—but real relief is not expected soon. The EIU forecasts a GDP contraction of 0.7% in the euro zone in 2012, recovering to growth of 0.5% in 2013. In real terms, these forecasts mean that the region's GDP will recover to 2008 levels only in 2013. Greece and Portugal are both forecast to experience sharp contractions this year. Spain and Italy—the most troubled of the large European economies—are facing somewhat milder shrinkage, and even Germany is expecting a slight contraction of 0.3%. Europe's sovereign debt troubles are far from over. Spain and Italy saw their ten-year bond yields fall early in the year, but only to the still-high neighbourhood of 5%, while the Greek debt reconstruction only succeeded in lowering the country's ten-year yields to just less than 20%.

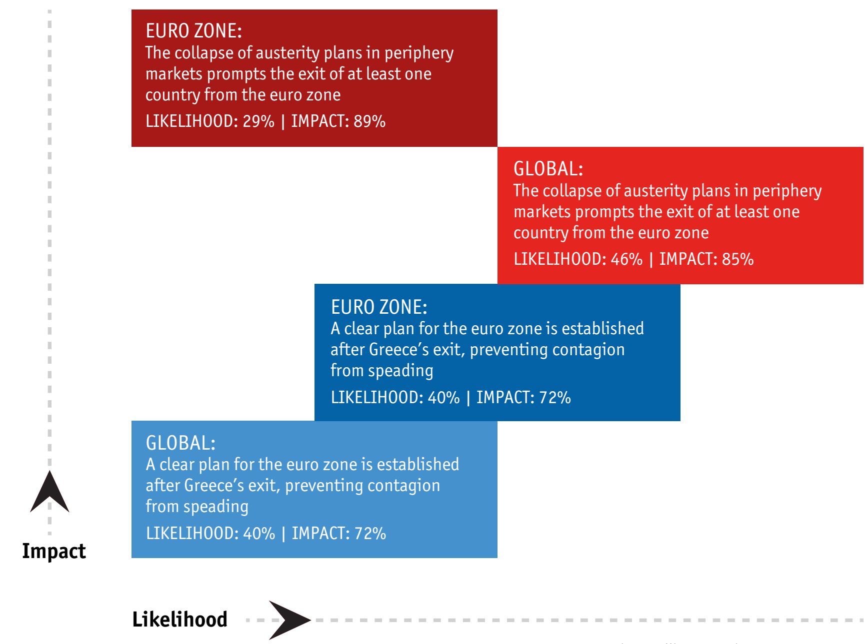
Corporations based in the euro zone are estimated to hold an unprecedented €2trn (US$2.6trn) in cash, with those based in the UK holding £750bn (US$1.2trn), according to the Institute of International Finance. This, combined with high risk premiums in some markets, the sustained efforts by banks to build capital buffers and the continued deleveraging by highly indebted households, will hold down investment and consumption until 2013, when growth will return—but feebly.

Investor sentiment echoes these grim forecasts. Only 17% of survey respondents consider the EU among their top markets for asset price growth potential in the next 12 months. More than 60% expect the euro itself to decrease in value—the worst projected performance for any currency covered in the survey and a dramatic turnabout from 2011, when 53% of respondents expected the euro to appreciate.

Some investors expressed positive surprise that the euro zone was able to avoid a major crisis thanks to the ECB's long-term refinancing operations (LTROs) and the Greek debt deal. But the negative forecasts—and the absence of any scenario for strong recovery any time soon—have prompted a great deal of speculation about the ultimate future of the zone itself. Recent political misjudgements in Spain have also eroded the recovery in investor confidence that accompanied the injection by the ECB of more than €1trn into regional financial institutions. Under the EIU's baseline forecast Greece is likely to remain within the euro zone for at least the next two years, as the government appears convinced that the costs of leaving, including an outright debt default, would outweigh any benefits. That said, keeping Greece in the fold could mean years more of financial support by euro zone governments, and possibly further debt write-downs. Meanwhile, the economic cost of austerity plans in other European countries is taking a political toll in Spain, Portugal and even the Netherlands and Finland, where Eurosceptic political parties are finding audiences.

Relatively few survey respondents hold out hope that European officials can hammer out a plan to

The euro zone: scenario analysis
(% of respondents)



Source: Economist Intelligence Unit survey, January 2012

prevent the spread of contagion from Greece to other troubled economies. Less than 30% say such a deal is likely. More than 46% of survey respondents agree it is likely that an austerity plan will collapse in one or more peripheral euro zone countries in the next 12 months, prompting those countries to abandon the single currency. More than half say that the impact on their portfolios of such an event would be negative.

Interestingly, euro zone-based investors are more optimistic about the fate of the currency union. While only 30% of global investors as a group agree that a clear plan for the euro zone will be established, 40% of investors based in the euro zone agree. Likewise, nearly half (47%) of global investors consider it likely that the collapse of austerity plans in peripheral markets will prompt the exit of one or more countries this year, but less than one-third (29%) of euro zone-based investors agree. The difference of opinion is perhaps in part because firms used to transacting most of their business in the euro area for the past decade have more to lose from its dissolution. The survey responses bear out this analysis: 72% of euro zone respondents say that a clear plan would have a positive impact on their portfolio or business, compared with 63% of global respondents. Similarly, 61% of euro zone respondents say that the exit of one or more countries from the euro zone would have a negative impact on their businesses or portfolios, compared with 51% of global respondents.

Euro zone-based investors are more optimistic about the fate of the currency union.

Optimism stems also from a strong feeling that European political leaders are solidly committed to avoiding the pain of a break-up. "They would stop it at all costs," says Antje Engelhardt Correa, international project finance and investment manager, Enercon GmbH, a German wind turbine and turn-key wind park manufacturer, referring to the departure of Greece from the euro. "It would be a problem for the whole of Europe—all the sovereign states. It might be seen as something that could happen if you are looking from outside Europe, but from within? No."

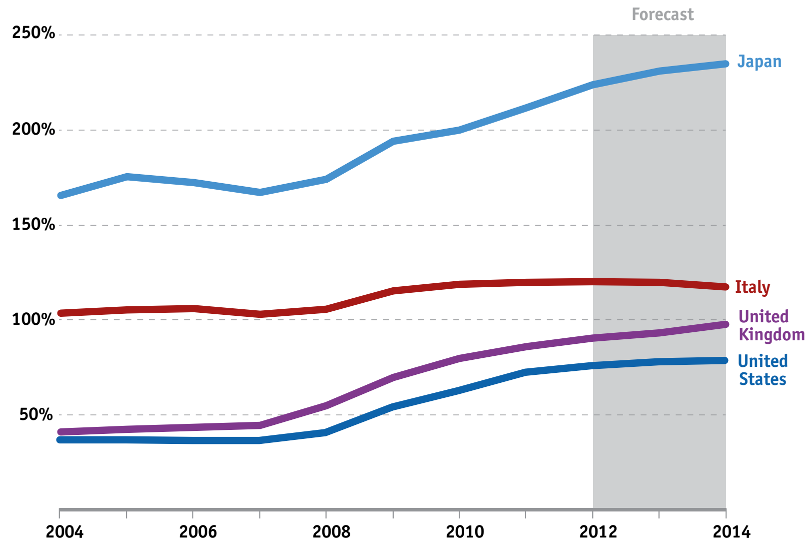
Investors based outside the euro zone, however, are seriously questioning how long the public in peripheral member states will go along with seemingly open-ended austerity measures. "The

LTRO has bought Spain and some of the other southern governments some time, but it's difficult forecasting how long it will be before the population's patience is used up," says Charles Robertson, global chief economist at London-based Renaissance Capital, noting that Spain is experiencing more than 50% youth unemployment. "It took Argentina three years and several presidents before they lost patience [with fiscal austerity]. That's the risk in southern Europe, which I think is a year or so away."

Sovereign debt anxieties: the next bubble

Excessive sovereign debt burdens are a problem not only in the euro zone. Higher—in some cases much higher—public debt burdens have been a growing concern for governments, investors and taxpayers in the developed world since the 2008 financial crisis, if not before. In the US the ratio of debt to GDP nearly doubled in two years and has continued to climb since then. In other developed countries public debt levels have exploded even more quickly, feeding concerns about fiscal instability, rising interest rates and, in the long run, a deterioration of economic competitiveness, as more and more of national income is devoted to debt service rather than productive capacity.

Heavy burden: Expansion of public debt
(% of GDP)



Source: Economist Intelligence Unit forecast

Nearly two out of three survey respondents attach a high probability to government debt ratios increasing. In the US, the ratio of public debt to GDP is forecast by the Economist Intelligence Unit to rise to almost 70% in 2012, up from 66% last year. The UK posted its largest-ever peacetime deficit—11% of GDP—in 2009, along with a 70% ratio of public debt to GDP. Despite enacting an emergency budget in June 2010 and setting a five-year plan for fiscal tightening, the EIU still expects public debt to rise to 90% of GDP, from 86% in 2011. Japan has also built a steadily higher level of public debt since the 2008 crisis, which the EIU expects to rise to 224% of GDP in 2012, up from 212% last year, giving it the largest such burden in the world.

What the US, the UK and Japan have in common is that despite their historically high levels of public debt, all three continue to enjoy low interest costs. All three have been beneficiaries of a "flight to quality" during the post-2008 recession and slow recovery, given their solid credit histories, large and diversified economies and stable institutions. The EIU expects the currencies of all three countries to appreciate in value in 2012.

Investor sentiment supports a continuation of low interest rates and high demand for "good" sovereign debt over the next one to two years. Reasons include continued global deleveraging along with the continuing threat of another crisis in less creditworthy countries in Europe.

Beyond that period, however, investors also agree that a bubble could appear in developed countries' markets for sovereign debt. Once credit problems are resolved elsewhere, these countries' debt may no longer be seen as a form of insurance, and investors may then reduce their holdings, forcing yields up. "If anything, they're overvalued, and that could reverse and have a strong impact on markets," Esteban Jadresic, chief economist and global investment strategist at Moneda Asset Management in Chile warns.

3 Geopolitics: The threat to oil prices

One reason for the extreme sensitivity to oil price disruptions may be that their economic effects are not as easy to shake off as in the past.

Even as the risk of a disorderly collapse of the euro zone has receded, the possibility of an oil price shock has emerged as the foremost threat to the global economy. The EIU forecasts that the benchmark price for dated Brent blend will average US$110/barrel in 2012, with a slightly higher price of US$115/barrel in the first half of the year owing to uncertainties created by the European embargo and sanctions on Iran. Following a surge in oil prices in early March, some analysts say they do not consider a price of US$5/gallon for gasoline to be out of the question in some parts of the US. This could seriously hurt the US recovery, not least via its impact on consumer confidence. Ben Bernanke, chairman of the Federal Reserve (Fed, the US central bank), recently told a congressional committee that "rising global oil prices are likely to push up inflation temporarily while reducing consumers' purchasing power".

These scenarios assume that a military confrontation between Iran, Israel and the US—specifically, an attack on Iran's nuclear facilities—does not take place. Should that occur, the EIU forecasts a severe oil price spike amounting to a 30-50% jump in prices in a matter of days or weeks, halting the global economic recovery and threatening another recession. Indeed, given the easing of the euro zone crisis following the LTROs and the Greek debt write-down, a possible oil price spike has now taken its place as the EIU's principal global economic concern.

If anything, investor sentiment is somewhat bleaker. Slightly less than one-third of survey respondents agree that US$150/barrel within the next 12 months is likely with or without a Middle Eastern crisis, and 26% think an attack by Israel on Iran's nuclear facilities is likely. Just over 70% of respondents say that an oil price of US$150/barrel would negatively affect them—the largest negative impact recorded for any of the scenarios included in the survey. According to 69% of respondents, the closing of the Strait of Hormuz would negatively affect them. However, the closing of the Strait by Iran in retaliation for US and EU sanctions is unlikely, some investors argue, since the economy most directly damaged would be that of Iran itself.

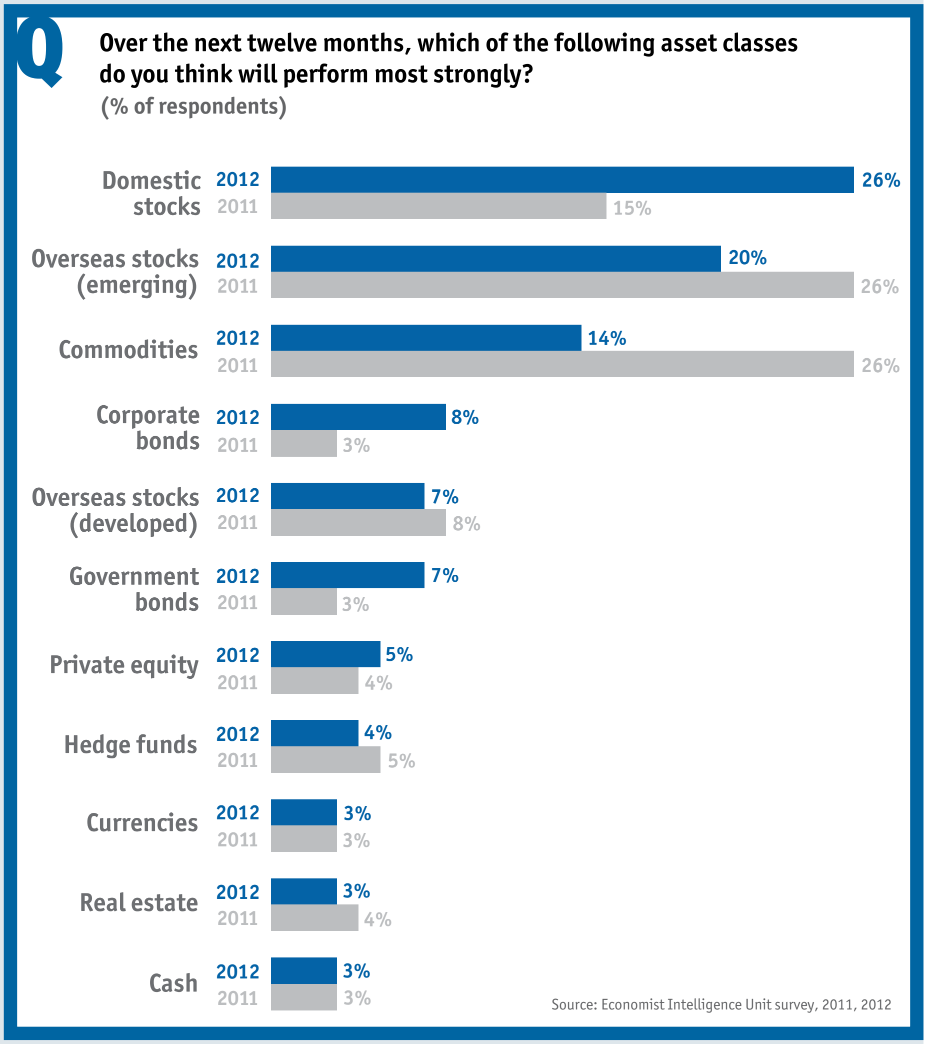
One reason for this extreme sensitivity to oil price disruptions may be that their economic effects are not as easy to shake off as in the past. Before the explosion in demand from emerging markets, investors could count on severe energy price hikes eventually stifling their own demand by dampening global economic activity. This self-correcting mechanism no longer works, Mr Robertson argues. Instead, consistently high demand for oil and gas from emerging markets—particularly China—tends to buoy prices even when developed economies are in a slump. Global energy demand is expected to grow only incrementally through the first half of the decade, according to the EIU. But while oil consumption in 2012 is expected to decline slightly in Europe and North America—indeed, across the entire OECD group of economies—owing to continuing economic sluggishness, it is expected to keep rising at a healthy pace in China and the rest of emerging Asia.

As a result, survey respondents expect oil and gas to be one of the highest-growth industries in the next 12 months. They cited oil and gas more often than any other category as being among the top three opportunities for revenue growth in 2012, although down from 2011. The sector was chosen by 29% of respondents this year, compared with 45% in 2011. ■

Moving away from commodities

Price pressure from major commodities other than oil is becoming more of a concern to investors. Almost one in four survey respondents agreed that water shortages could spark a regional conflict somewhere in the world, and 57% said such an event would have a negative impact on their portfolios—10% thought this could be very negative.

In a notable turnaround from last year, however, commodities lost their place as the asset class that global investors expect to perform best over the next 12 months. This reflects lower demand for many raw materials from sluggish developed markets in the euro zone and elsewhere. Another reason, some investors noted, may be a desire by large institutions to concentrate on highly liquid assets during a time of uncertainty. Only 14% of survey respondents cited commodities as their expected top performer, down from 26% in 2011, when they tied for the top spot with emerging-market equities. The latter fell off their perch as well, displaced by domestic equities, which were picked by 26% of respondents. ■

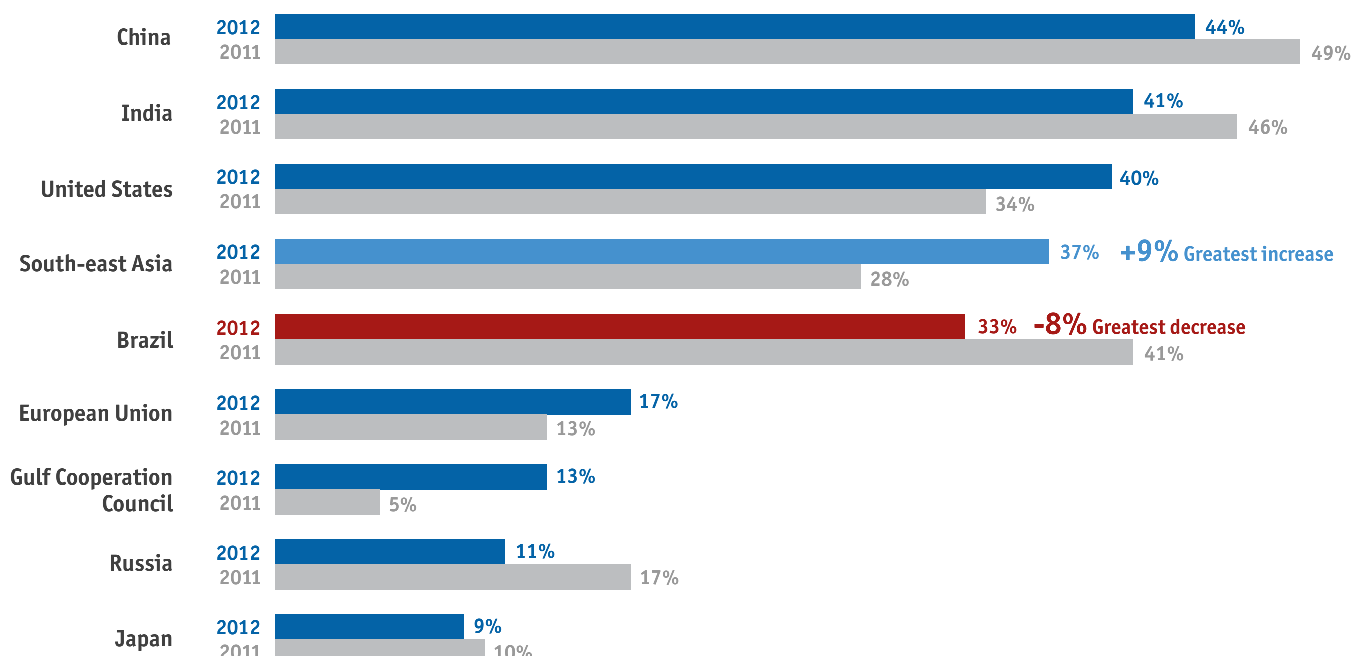


Source: Economist Intelligence Unit survey, 2011, 2012

4 The US: Risk/reward target

Investors are taking heart from the US economy's modest upturn. The US economy, by almost any measure, remains weak: the unemployment rate is alarmingly high (above 8%), housing prices continue to fall, and debt levels are elevated. However, the economy grew at an annualised rate of 3% in the fourth quarter of 2011, its fastest rate in six quarters. This was buoyed by unexpectedly strong consumer spending, although much of the new activity was attributed to inventory replenishment. The stockmarket has responded strongly to these positive signs: by mid-March the S&P 500 had posted an 11% advance from the start of the year.

Q Which of the following regions and countries offer the best potential for asset price growth over the next twelve months?
(% of respondents)



Source: Economist Intelligence Unit survey, 2011, 2012

Some see the impending presidential election as a positive force, discouraging either political party from engaging in more of the budgetary brinksmanship that punctuated 2011.

The EIU forecasts US GDP growth of 1.9% for 2012, a 0.2% improvement over 2011. Japan, which is in disaster reconstruction phase, is the only other leading economy within the OECD where growth is expected to be stronger this year than in 2011. In this year's survey the US has jumped from fourth to third place for asset price growth, with slightly more than 40% of respondents placing it among their top three markets, just behind China (44%) and India (41%) and ahead of South-east Asia (37%). "The US is the place with respect to the risk/reward trade-off," says Jaya Shankar, executive director of HDIL Securities Ltd in India, noting also that Standard & Poor's downgrade of US Treasury securities last year did not lead to investors abandoning the US dollar, reflecting in part the unrivalled depth of the US capital markets.

But the optimism with which investors appear to have greeted these positive signs may be misplaced: while the US economy has gained ground in the last six months and another recession in the short term seems unlikely, most economic indicators have not displayed the consistent upswing that might have been expected during a normal recovery from recession.

Some see the impending presidential election as a positive force, discouraging either political party from engaging in more of the budgetary brinksmanship that punctuated 2011. The administration of Barack Obama plans no further fiscal tightening in 2012, but a series of fiscal deadlines just after the election, including the expiration of the Bush administration's tax cuts and the due date for the massive spending cuts mandated under last year's deal to raise the federal debt ceiling, would tend to encourage both parties to once again attempt a grand bargain that could result in significant deficit reduction. Whoever wins the presidency in November will face pressure to cut federal spending in 2013. If the economic recovery continues, the pressure to cut federal spending—and borrowing—to avoid a "crowding out" of private investment will intensify. The result would be fiscal belt-tightening, which could hinder a faster economic recovery—at least in the short term. ■

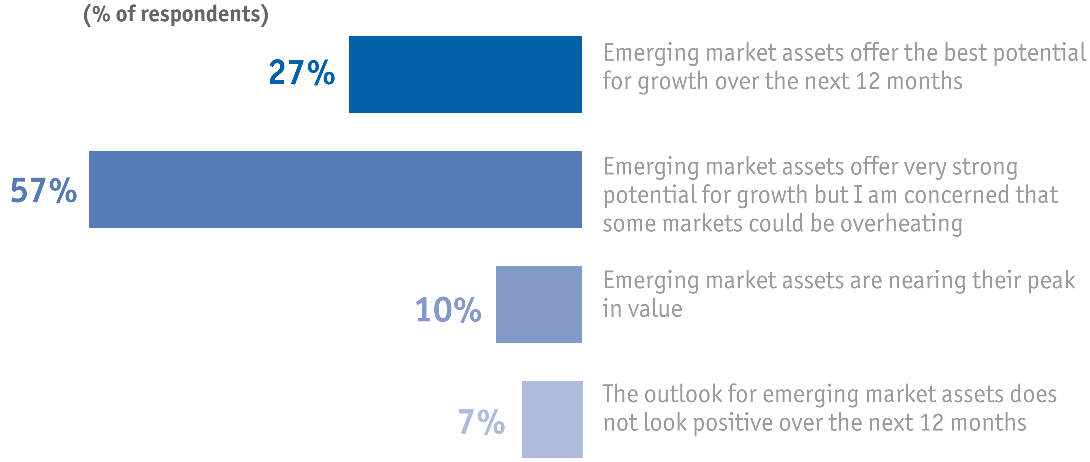
5 Emerging markets: Supporting the global economy

Survey respondents overwhelmingly selected emerging markets as offering the best potential for asset growth over the next 12 months.

In stark contrast to economies in the developed world, the largest emerging markets continue to perform strongly. Booming exports to these countries helped to buoy poorer economies in Sub-Saharan Africa and South America, which might otherwise have slipped into recession after 2008. Whereas non-OECD countries are projected collectively to post 5.5% real GDP growth in 2012, OECD countries taken together are expected to post growth of just 1.2%, with improved performances in the US and Japan outweighed by recession across much of the EU. Not surprisingly, therefore, survey respondents overwhelmingly selected emerging markets as offering the best potential for asset growth over the next 12 months, with 82% agreeing with that statement. In contrast, only 7% deemed the outlook for emerging markets not to be positive, and only 10% said that emerging markets were nearing their peak.

Of course, some concerns were expressed as to how long these fast-growing economies can maintain this pace, especially if demand from the developed world continues to be soft. Although domestic demand is beginning to play a bigger role as middle classes emerge and become more prosperous, this process is still in its infancy, and exports remain a key driver of growth for many emerging markets. The largest emerging markets—

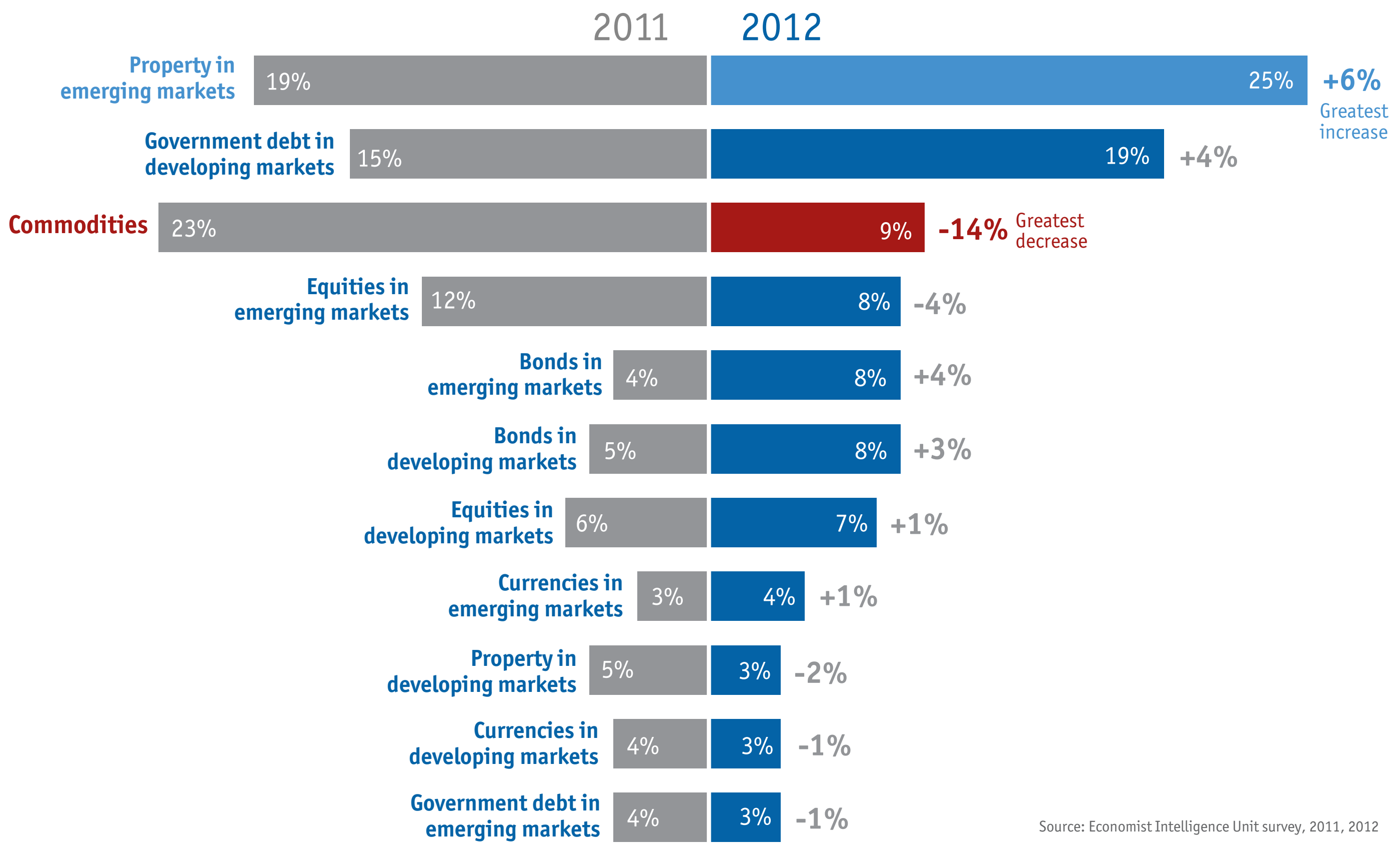
Q Which of the following statements best expresses your view of investing in emerging market assets?
(% of respondents)



Source: Economist Intelligence Unit survey, January 2012

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

(% of respondents)



Source: Economist Intelligence Unit survey, 2011, 2012

China, Brazil and India—slipped from last year as the top asset-growth performers. While China remained the top-ranked, it was by a smaller margin than last year, and overheating remains a concern. This is in line with a lower growth forecast for this year. Fifty-six percent agree with the statement that "emerging-market assets offer very strong potential for growth, but I am concerned that some markets could be overheating", although this was down from last year's 66%.

David Chapman, director of risk management at the Catholic Healthcare Investment Management Company in the US, said his team holds a positive view of emerging markets but are sensitive to those countries, like South Korea, with the greatest exposure to struggling developed economies. Asked where the next market bubble was likely to develop, 25% of respondents mentioned property in emerging markets, the most of any category this year, displacing commodities, which were most often named in the 2011 survey. Since the survey was conducted at the beginning of this year, policy action in China and an overall slowdown in Brazil have largely dispelled the risk of a property bubble. This would change if China, or other governments, took fright from a rapid global slowdown and launched another massive stimulus package, in which case cheap money would probably gravitate towards the property markets in emerging economies. ■

China: Broadly optimistic

China has continued to enjoy annual GDP growth above 10% in recent years, although concerns related to the housing market and softer demand for exports have prompted lower expectations for 2012. The Economist Intelligence Unit forecasts growth at 8.3% in 2012, down from 10.1% in 2011. The announcement in March by the Chinese premier, Wen Jiabao, of a scaling back of the official minimum growth target for 2012 to 7.5% (from 8% in recent years) signals the authorities' recognition that China is entering a phase of slower growth, although in practice these targets are usually floors.

Survey respondents were more positive about China's potential for economic growth in the next 12 months than they were about its likely asset-growth performance, with nearly 60% expecting it to be positive. Chinese investors themselves are among the most optimistic, with 45% saying they expect domestic stocks to be their top performers, the most selected asset class by a significant margin. However, according to a similar percentage of respondents, these are most likely to carry a higher level of risk.

Lower demand for Chinese goods from slumping developed markets has yet to be counterbalanced by a substantial increase in domestic consumption. The country recorded a trade deficit of US$4bn at the start of 2012. The end of a long boom in up-market housing is also generating concern. In February housing prices in 100 major cities in China fell for the sixth consecutive month, based on data compiled by China Real Estate Index System, partly as a result of a deliberate policy of reining in speculators in high-end developments. However, the Chinese New Year celebrations—which fell on January 23rd this year—will have influenced February's economic data.

The EIU nevertheless expects the Chinese authorities to engineer a soft landing. This is mainly because the alternative—a large stimulus to stave off a slowdown for a year or two—would drastically dim the long-term outlook for the Asian giant by expanding government debt to dangerous levels. Over half of all survey respondents (54%) agree that the chances of the Chinese authorities launching another massive stimulus are slim.

Over half of all survey respondents agree that the chances of the Chinese authorities launching another massive stimulus are slim.

However, the possibility of a more serious outcome cannot be ruled out. A severe euro zone recession or higher oil prices would have a big impact on China and its main export customers. That, in turn, might prompt the Chinese government to implement a major stimulus package on a similar scale to that of 2008, especially since a major leadership reshuffle is due to take place during the coming year. The spectre of labour unrest in China's manufacturing belt could frighten policymakers into abandoning their current prudence. However, 84% of investors surveyed consider it unlikely that a local incident would spread to become a nationwide political opposition movement.

Investors suggest the government might instead introduce a series of low-key, targeted stimulus packages designed to encourage lending and fund infrastructure projects. Targeted stimulus could also be aimed at building up inland cities, more advanced manufacturing and transport and infrastructure, suggests Tze Hoe Chan, director at Zendo Holdings, an Asia-focused strategic and private equity advisory firm in Singapore. This would help keep low-wage jobs from leaving the country, since companies could instead shift them from the coastal regions to inland cities.

The housing market remains a focus of concern, but the government has taken measures to prevent a sharp decline, including greater public expenditure on social housing and relaxed reserve requirements for banks. Only one-third of survey respondents consider it likely that a housing market crash will occur in China in the next 12 months, although 66% agree that such an event would have a negative impact on their portfolios. However, a housing bubble in China would be on a far smaller scale than the one that tripped up the US in 2007-08, as Steffen Bassler, director at Credit Suisse Securities (Europe), points out. Chinese real estate markets are far less globally connected than US markets. Additionally, China is better able to absorb the shock, according to Michael Strauss, chief investment strategist and chief economist at Commonfund in the US, since a collapse of demand at higher price points can be partially buffered by a large demographic demand for housing at lower prices. ■

Asia and Latin America: New focus on smaller markets

Slower growth in China and India is shifting attention to some of the smaller economies, particularly in South-east Asia. Smaller economies are likely to benefit from demographic trends—such as relatively young populations—as well as economic and political factors such as low wage costs, low public and private debt levels, rising domestic consumption and deepening financial markets. Together, these factors add up to a more reassuring environment for business than in the larger economies.

The Economist Intelligence Unit expects Asia and Australia (excluding Japan) to continue to grow strongly in 2012-16—indeed, to remain the fastest-growing region in the world, expanding by more than 6% a year at market exchange rates. Rising domestic consumption and rising wage costs in China are expected to stimulate production in lower-cost neighbouring countries. Bangladesh, Vietnam, Cambodia, Sri Lanka and Indonesia are expected to benefit from these trends.

Smaller economies are likely to benefit from demographic trends as well as economic and political factors.

India may contribute to the trend as well. Like China, it is experiencing lower growth. The EIU has dropped its real GDP growth forecast for 2012-13 to 6.9% from 7.2% in 2011. In the long term private consumption and investment should drive stronger growth, but inflation may temper that. Although inflation has slowed from 8.9% in 2011, it remains stubbornly high, and the threat of a surge in global oil prices, precipitated by an escalation of geopolitical tensions or a failure of the monsoon—a perennial concern in India—could see the inflation rate jump.

Investor sentiment is beginning to reflect these shifts. As was the case last year, China and India were most often mentioned in the Economist Intelligence Unit's 2012 *Search for growth* survey as offering the best opportunities for asset price growth. Brazil contracted slightly in the third quarter of 2011, owing to policy tightening in the first half of the year, leading to concerns of a sustained slowdown. It slipped to fifth place overall, selected by 35% of respondents, down from 41% in 2011. Taking its place is South-east Asia, selected by 37% of respondents, up from 28% in 2011.

In a similar fashion, some investor attention is starting to shift from Latin America's giants to some of the region's smaller economies. Growth throughout the region declined markedly in 2011, hurt in part by falling export demand. Brazil was especially hard hit, dropping from a blistering pace of 7.5% to 2.9% real GDP growth. The EIU is forecasting a recovery to 3.3% in 2012, buoyed by a 14.3% rise in the minimum wage that is expected to boost consumption. A stronger pick-up is anticipated in 2013, as the effects of the ongoing monetary easing cycle, coupled with a relaxation in credit restrictions, are felt, fiscal policy becomes more expansionary and public banks boost lending. Colombia, Peru and Chile are also expected to experience slower growth in 2012. But their levels are expected to remain fairly robust at 4.9%, 5.1% and 4.3% respectively, in part owing to recovering demand in the US and the resilience of markets within Latin America itself.

Still, only 19% of survey respondents named Latin America as one of the best prospects for economic growth in the next 12 months, little more than half the percentage who mentioned Brazil specifically. Esteban Jadresic, chief economist and global investment strategist at Moneda Asset Management in Chile argues that Brazil's economy has been overheating, spurred by rapid credit growth and threatened by a tight labour market, suggesting it "is going through an adjustment to maintain a stable economy going forward". The over-valuation of the Real may also be a cause of concern. According to Jim O'Neill of Goldman Sachs the Brazilian currency needs to decline in value by 20% to keep Latin America's biggest economy competitive. ■

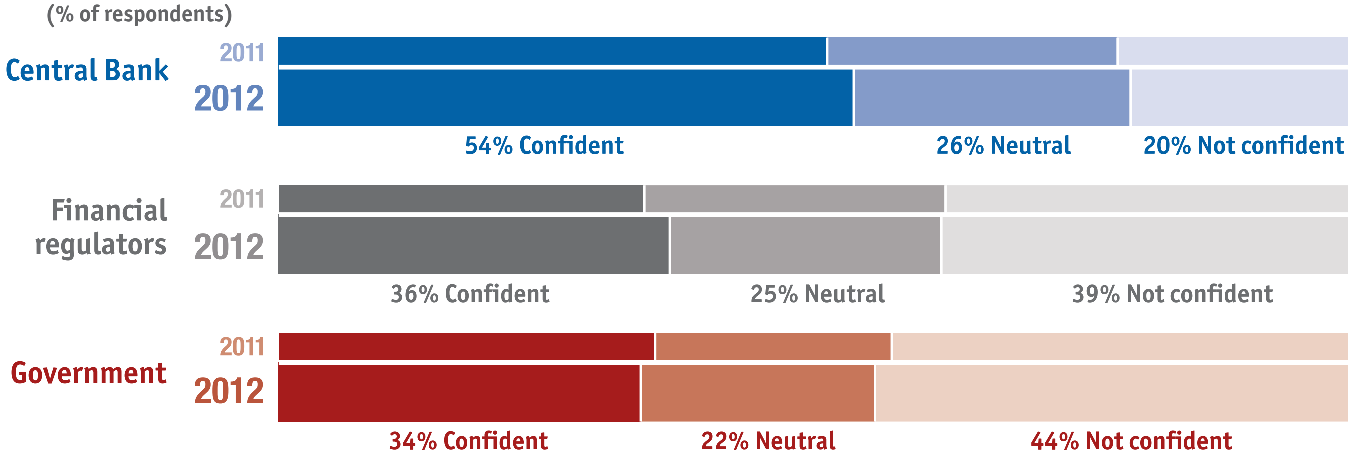
6 Monetary policy, inflation and interest rates

"Central banks and finance ministries have the toughest job in the world right now," says Patrice Conxicoeur, managing director, global insurance coverage at HSBC Asset Management (Hong Kong) Ltd., "but I'm agnostic on whether they'll get it right." In the wake of the 2008 crisis these institutions have repeatedly intervened to shore up liquidity in key markets while attempting to manage a soft landing in China and collaborate on a write-down of Greek debt. Many of the tasks they have taken on are unprecedented, requiring them to assume non-traditional responsibilities and engineer creative solutions in crisis situations. The Fed's "Operation Twist" last autumn may have enabled the US recovery to continue, while the ECB's two LTROs stabilised bank funding markets in the euro zone.

Much of this was controversial, but according to the survey these interventions have boosted investor confidence in central bankers' handling of monetary policy—and thus in the political underpinnings of future economic growth. Survey respondents expressed greater confidence in central bankers this year than last—54%, compared with 51% in 2011. In contrast, only 36% of respondents said they were confident of governments' ability to make the right decisions, down slightly from 2011. Central banks understand

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

(% of respondents)



Source: Economist Intelligence Unit survey, 2011, 2012

> “There’s a halo effect on central banks, because they’re more independent of politics.”
>
> Steffen Bassler, director, Credit Suisse Securities (Europe) Ltd, UK

economies and business mechanics better than governments, Mr Bassler says. “There’s a halo effect on central banks, because they’re more independent of politics.” However, as Mr Chapman notes, their efficacy is limited if lawmaking bodies do not have the expertise to work with them rather than being at cross-purposes.

Recent events suggest that the gulf in confidence could narrow. In the US, the Fed and the Treasury Department have had to work closely together to stabilise that country’s banking system since 2008. In Europe, the “troika” of the ECB, the IMF and the European Commission succeeded in pulling together euro zone national governments and leading holders of Greek debt in the recent deal to write down and reorganise that debt.

One key investor concern—inflation—appears to be firmly under control. The EIU forecasts global inflation to drop from 3.9% in 2011 to 3.3% this year and to hover around that level through to 2016. Factors contributing to the reduction include a decline in food prices, which were a major source of concern last year; a decline in property prices in China, which had been generating inflationary pressures in that country; and continuing high unemployment in slowly recovering developed markets.

“There’s so much unemployment that it’s hard to see where inflation could come from,” notes Ben Whitmore, manager of the Jupiter UK Special Situations Fund (Unit Trust) at Jupiter Asset Management. A Swedish banking official, who asked to remain anonymous, argues that too much deleveraging still needs to take place for inflation to gain a foothold. Michael Taylor, CEO of the London Pensions Fund Authority, and Mr Strauss agree that the one potential source of inflation in the next 12 months would be an exogenous event such as an oil price spike, rather than events in the economy itself or a policy decision.

The softening of global demand this year compared with 2011 and the ongoing fragility of the global economy have led respondents to expect that interest rates will remain largely stable. In 2011 the majority of respondents expected rates to rise in the US, the UK, China and the euro zone—the only exception was Japan. Now the majority expect rates to hold steady for the next 12 months in all major markets.

Interest rates in developed markets have been very low since the global recession, and since late 2011 have been on a loosening trend in many key emerging markets as those economies have slowed. China, for example, stopped raising rates in the second half of 2011 and is not expected to boost them again until late 2012. Brazil has now been easing rates since August 2011 and is expected to keep them low (at least by Brazilian standards) until 2013. In India, which began raising rates steadily in January 2010, the central bank recently decided to hold them at 8.5%; a cut is now widely expected.

Concerns are beginning to build about how long the current phase of very low interest rates can last, however. Debt loads are growing rapidly in developed markets such as the US, Japan and the UK, which have taken advantage of low rates to facilitate their increased borrowing. James Davis, vice president of strategy and asset mix at the Ontario Teachers’ Pension Plan, a public pension fund with about C$117bn in assets, cites brewing concern about the impact of low rates on pension liabilities, which could force some employers to make larger contributions to plans if it persists. ■

7 Conclusion: Breakthroughs and positive surprises?

Many of the threats that investors were unaware of a year ago or downplayed are now out in the open.

Consistently, global investors say what concerns them most is the impact of geopolitical events—the potential for a conflict in the Middle East or a disorderly default and departure by a euro zone country—rather than events in the markets. However, they do not expect any of these to occur in the next 12 months. A tempered optimism seems to have taken hold in the investor community. One reason may be that many of the threats that investors were unaware of a year ago or downplayed—the European debt crisis, Middle East instability and unpredictable natural disasters, such as the tsunami in Japan—are now out in the open. However, particularly in the euro zone there is concern that the improvement in sentiment may lead to a misplaced complacency that these threats have been dealt with.

"I'm not concerned about a bubble," Mr Conxicoeur notes. "These aren't boisterous times, risk aversion is high, and that suggests people are alert and cautious." The European crisis is more of a concern for the long run than tensions with Iran, Mr Robertson argues, since he believes the latter threaten a severe crisis, but one that is finite and quantifiable. The dislocations already being caused by the European crisis, in contrast, may be massive, difficult to calculate, and ongoing.

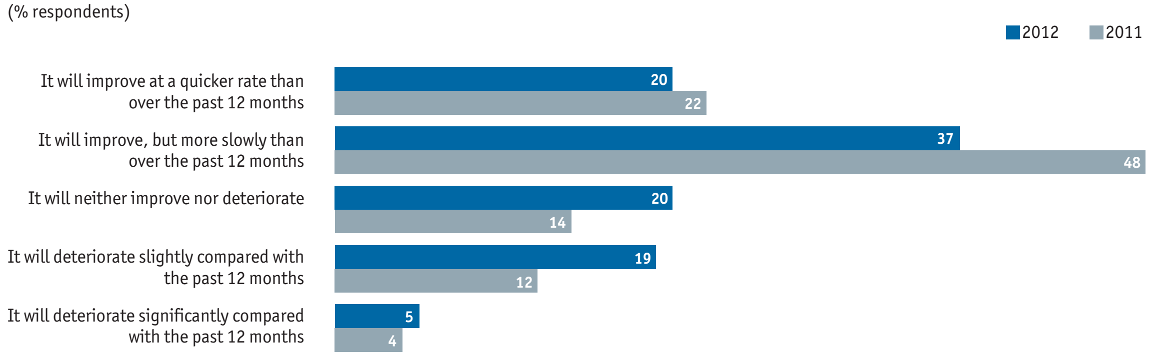
"If there's going to be a crisis," he adds, "my suspicion is it will be from something we're not thinking of." Just over 30% of survey respondents said it was likely that a cyber attack could bring down a Fortune 500 company in the next 12 months, for example—a disaster that more than 52% said would affect them negatively.

Global investors continue to ponder other possibilities, some of which are reflected in their responses to the scenarios presented in this year's study. A breakthrough in broadband technology, ramping up the use of mobile computing, was deemed likely by 49% of survey respondents, with almost two out of three saying it would have a positive effect on their portfolios. Half thought a breakthrough in the development of an efficient and cost-effective battery for electric cars was likely, with almost half saying this would have a positive effect on their investments. Breakthroughs and positive surprises, then, could be a feature of the next 12 months as well. ■

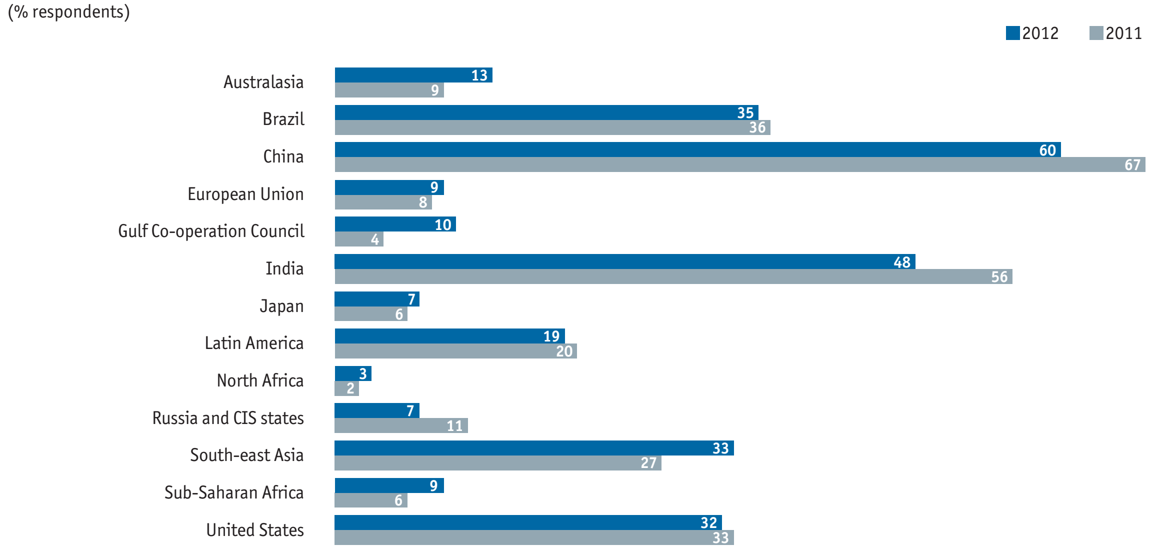
Appendix: Survey results

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

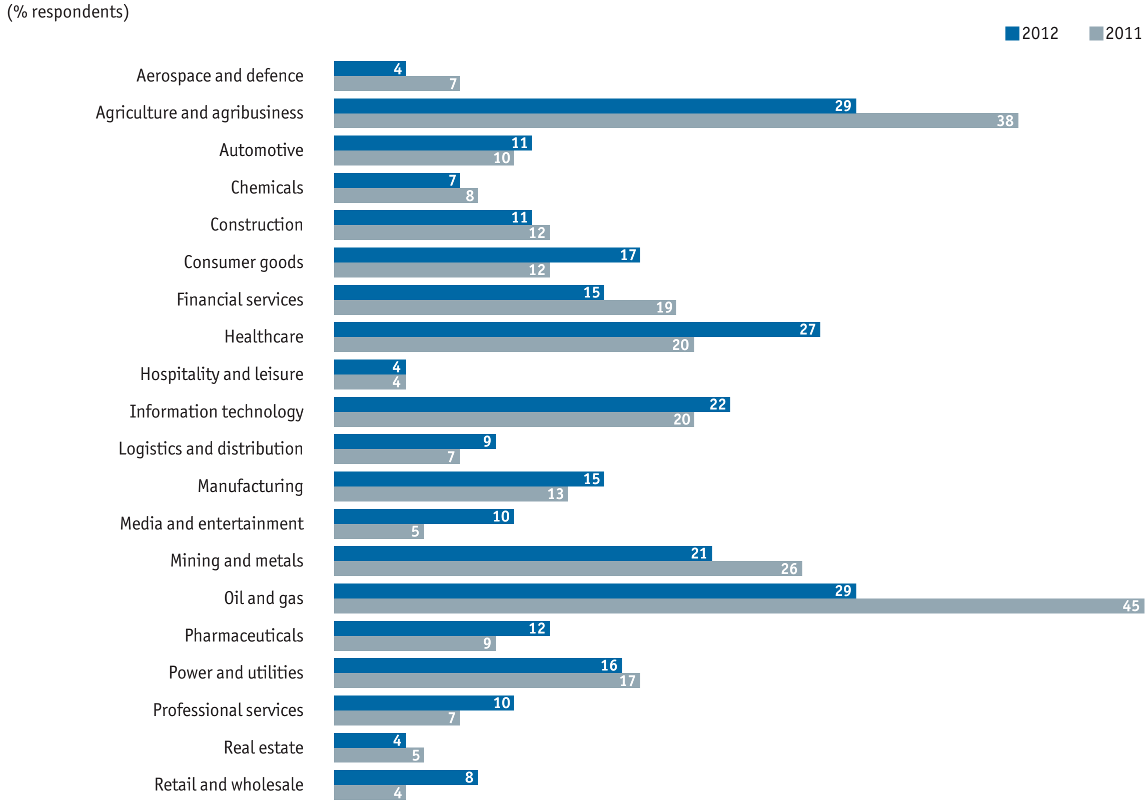
Which of the following statements best expresses your view on the outlook for the global economy over the next 12 months?
(% respondents)



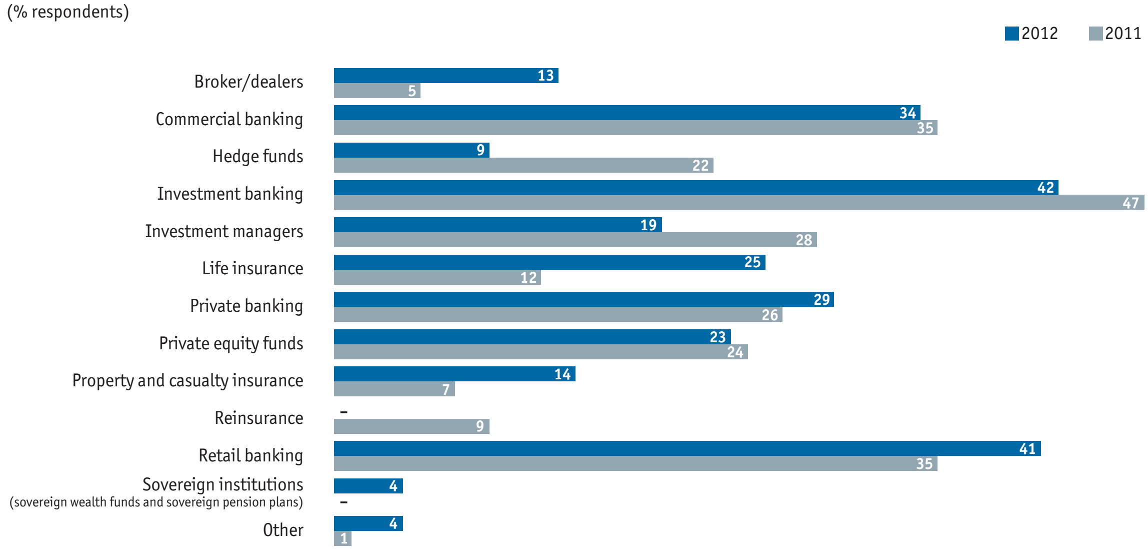
Which three countries/regions of the world do you think offer the best prospects for economic growth over the next 12 months?
Select up to three.
(% respondents)



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



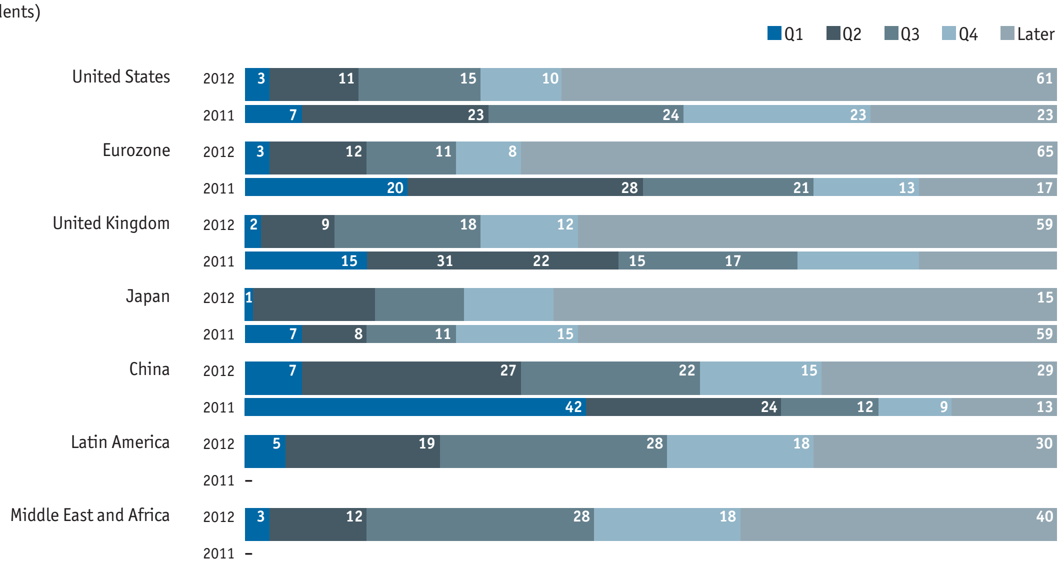
Which of the following sub-sectors of financial services do you think offer the best opportunities for revenue growth?
Select up to three.
(% respondents)



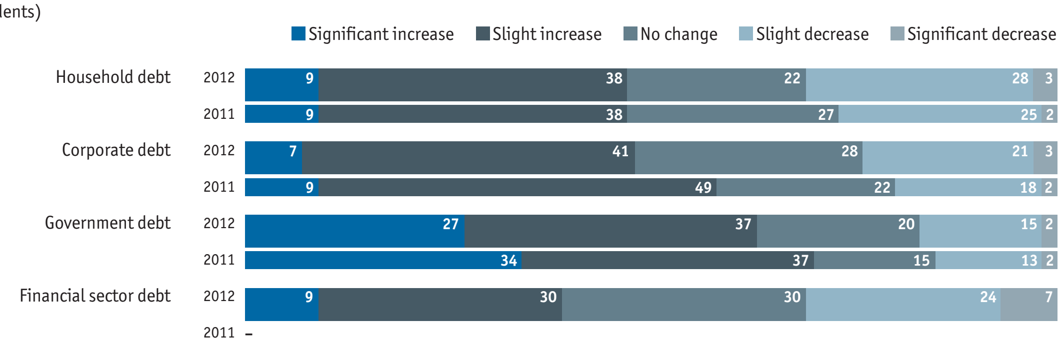
On average, what is your expectation for the level of consumer price inflation in the market in which you are personally based over the next 12 months?

	2012	2011
+10%	3 %	3 %
+9%	1 %	1 %
+8%	2 %	4 %
+7%	3 %	5 %
+6	4 %	6 %
+5%	8 %	14 %
+4%	14 %	17 %
+3%	26 %	24 %
+2%	26 %	18 %
+1%	8 %	5 %
0	3 %	2 %
-1%	1 %	1 %
-2%	1 %	0 %
-3%	0 %	1 %
-4%	0 %	0 %
-5%	0 %	0 %
-6%	0 %	0 %
-7%	0 %	0 %
-8%	0 %	0 %
-9%	0 %	0 %
-10%	0 %	0 %

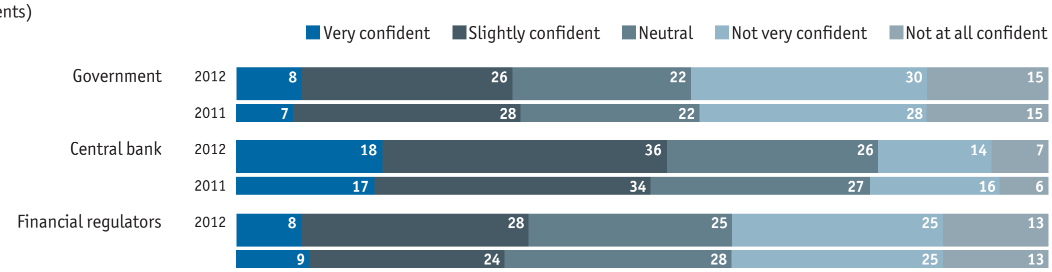
When would you expect headline interest rates to be raised in the following regions or countries?
(% respondents)



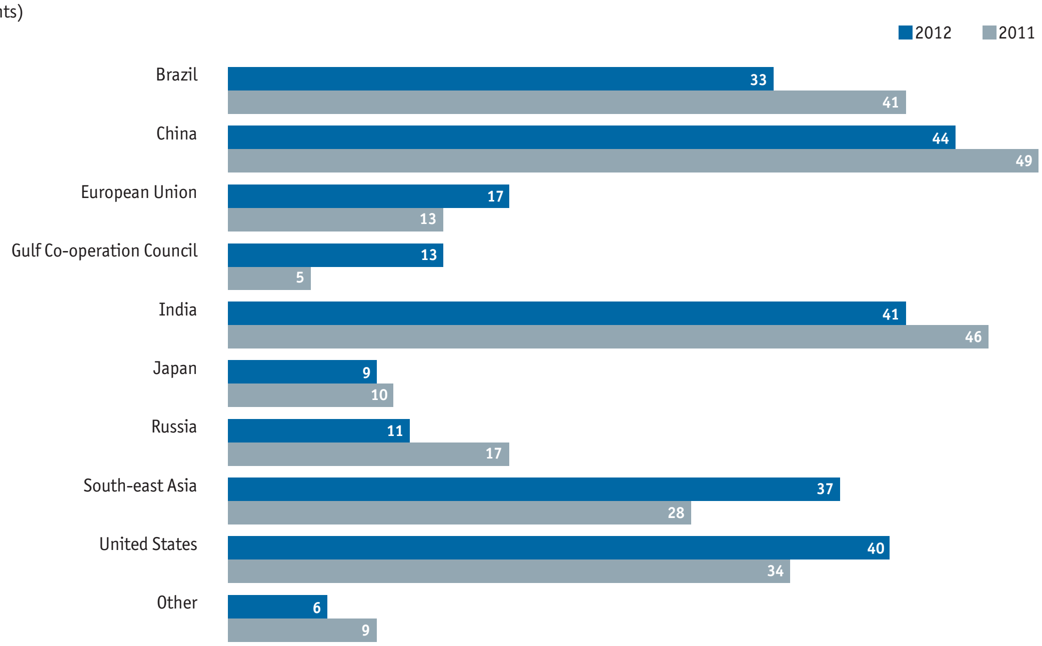
Over the next 12 months, what change do you expect to debt ratios across the following categories in your domestic market?
(% respondents)



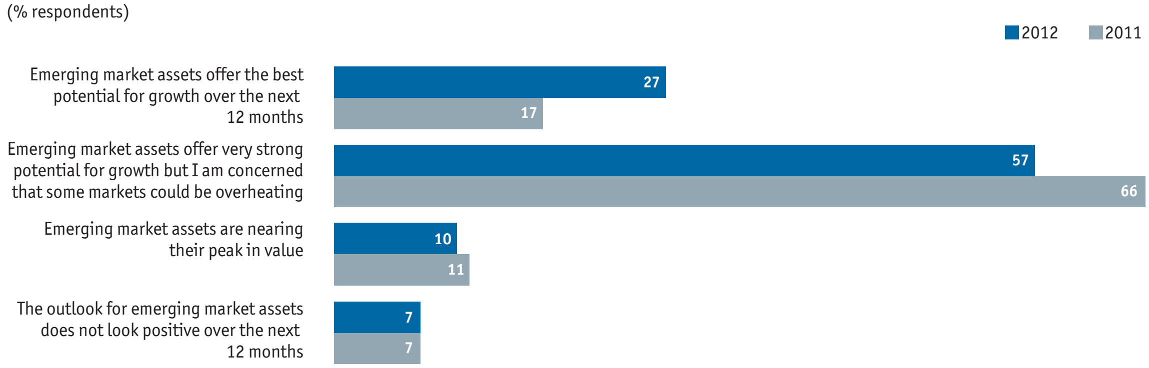
How confident are you in the abilities of the following administrations to make the right decisions to ensure strong performance in your domestic economy over the next 12 months?
(% respondents)



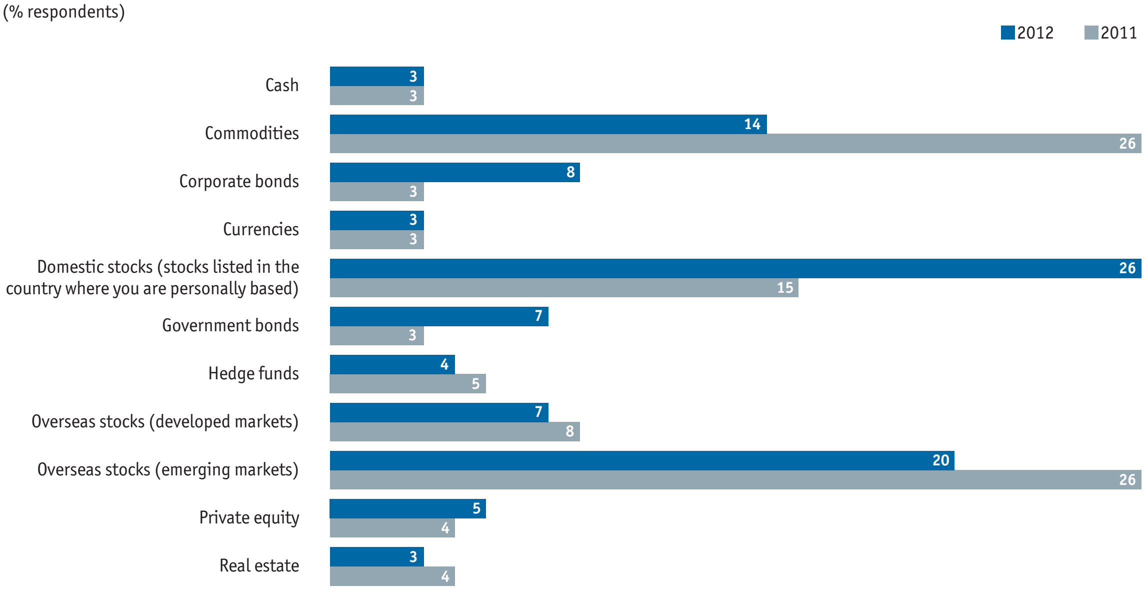
Which of the following regions and countries of the world do you think offer the best potential for asset price growth over the next 12 months?
Select up to three.
(% respondents)



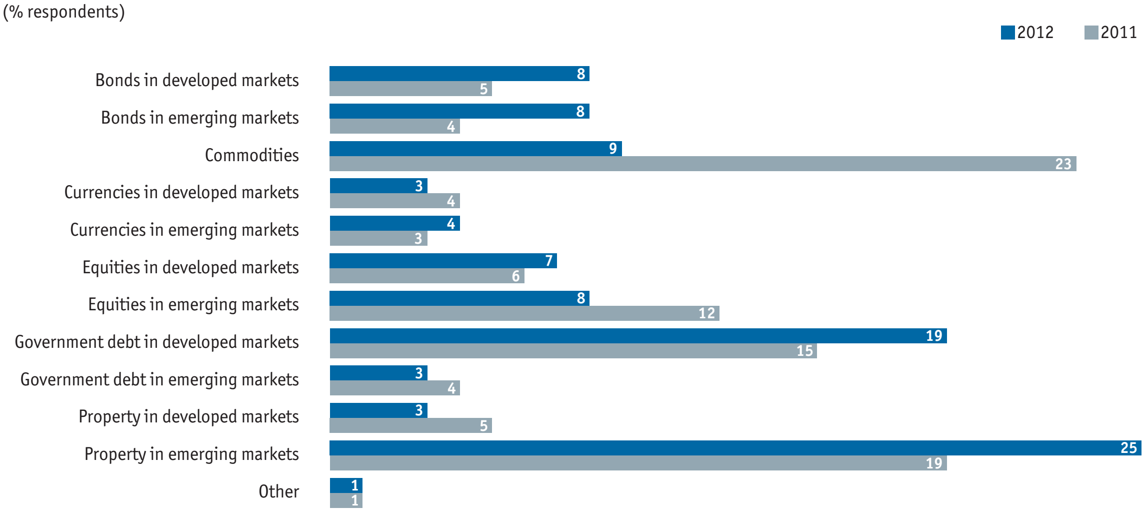
Which of the following statements best expresses your view of investing in emerging market assets (eg, BRIC countries)?
(% respondents)



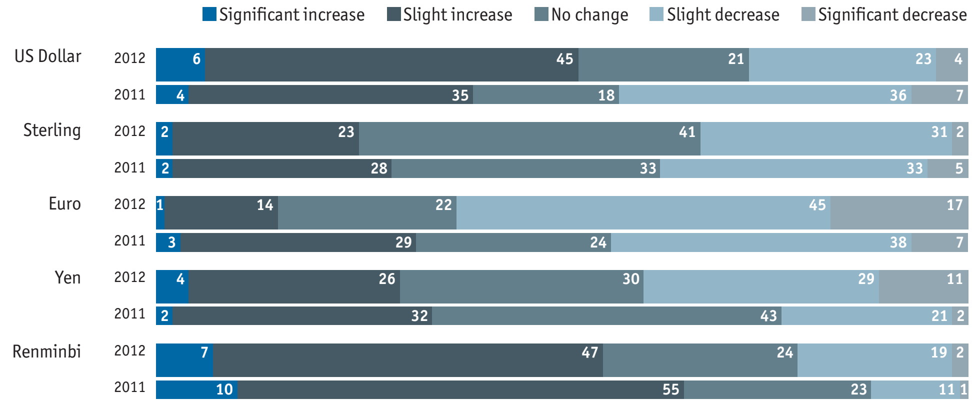
Over the next 12 months, which of the following asset classes do you think will perform most strongly?
(% respondents)



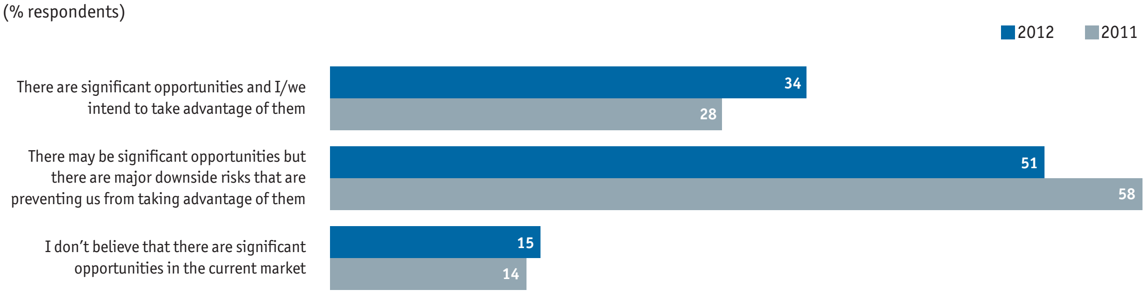
In your view, where is the next asset price bubble most likely to form?
(% respondents)



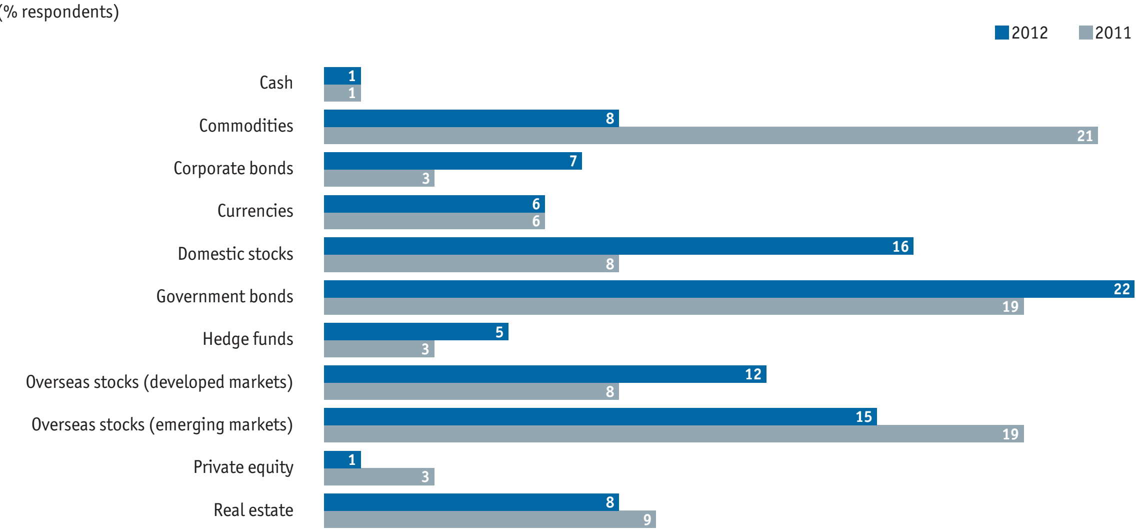
Over the next 12 months, what change do you expect to the value of the following currencies?
(% respondents)



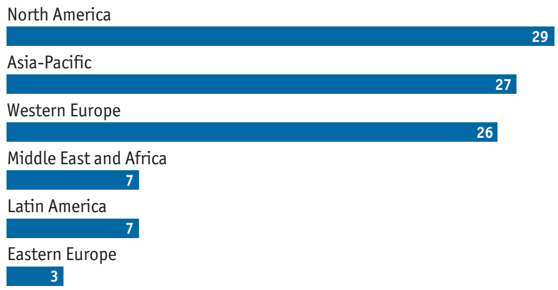
Which of the following statements best expresses your view about current growth opportunities in the financial markets?
(% respondents)



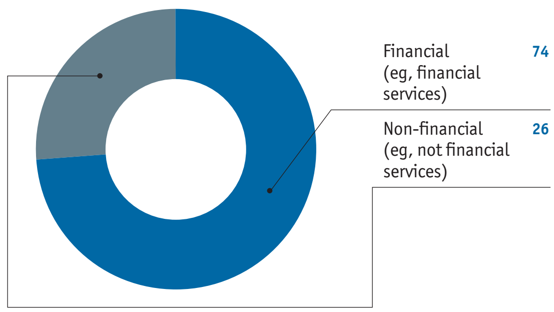
Which of the following asset classes do you think are most likely to increase in level of risk over the next 12 months?
(% respondents)



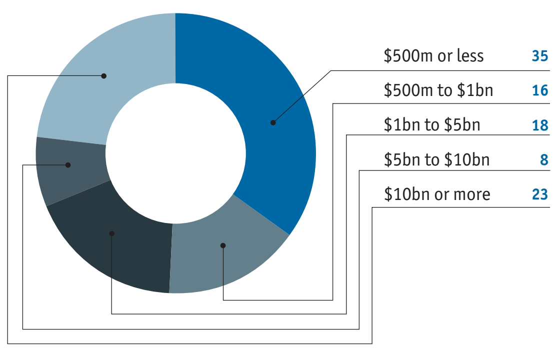
In which region are you personally located?
(% respondents)



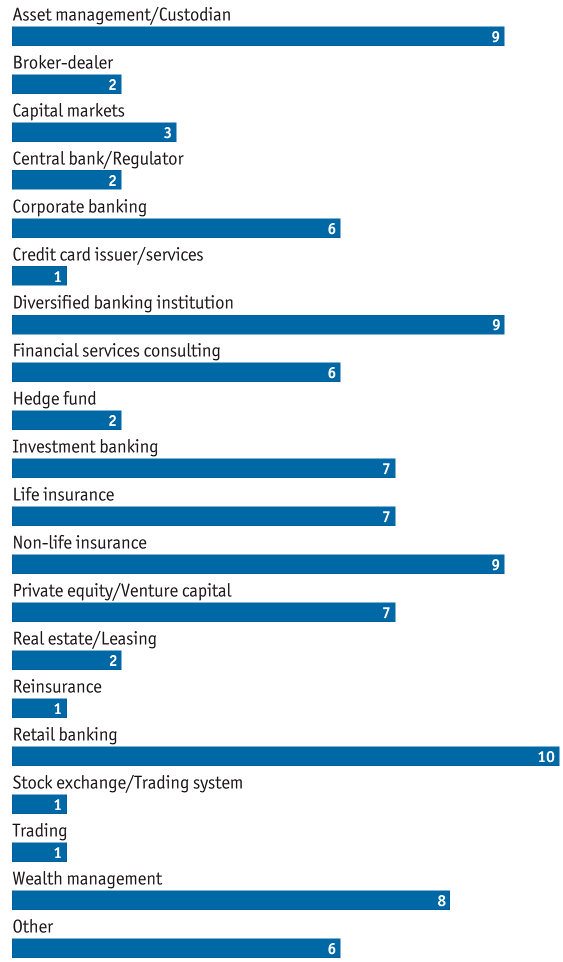
What type of organisation do you work for?
(% respondents)



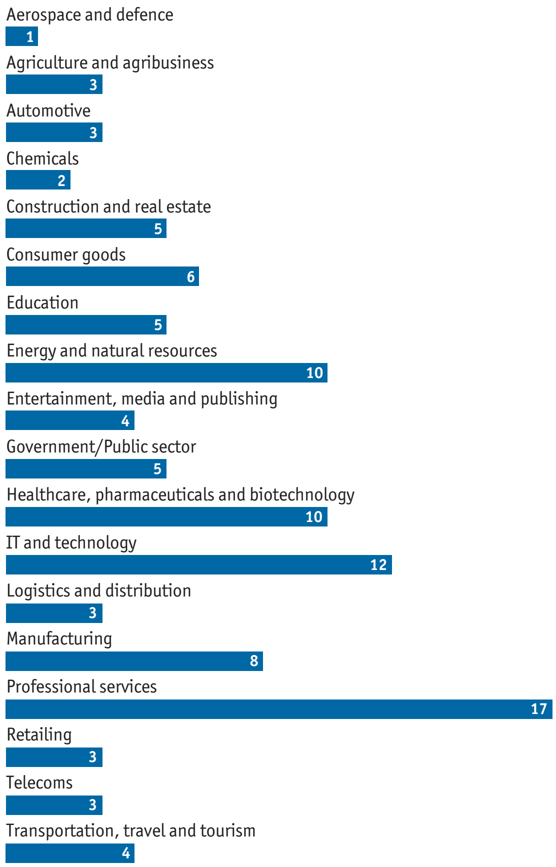
What are your company's annual global revenues in US dollars?
(% respondents)



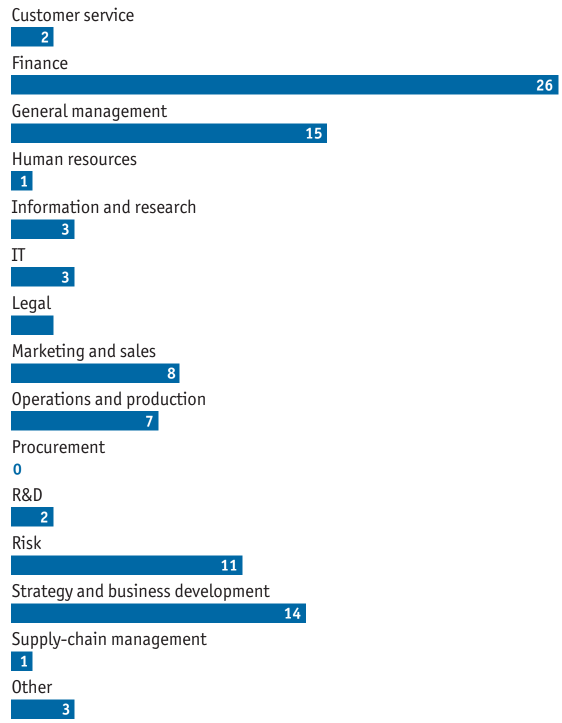
In which subsector of financial services does your organisation primarily operate?
(% respondents)



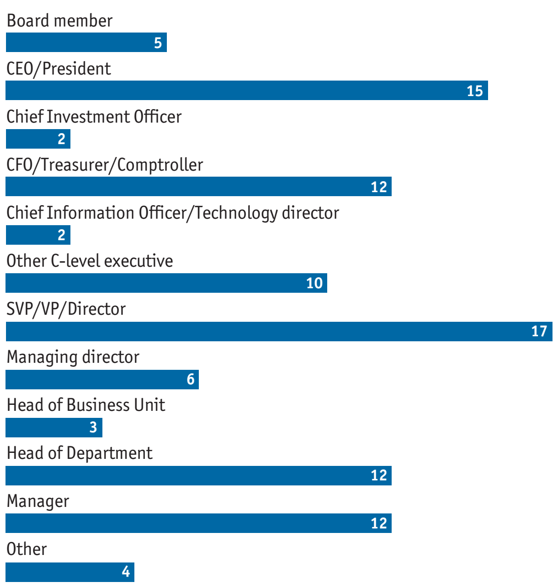
What is your primary industry?
(% respondents)



What is your main functional role?
(% respondents)



Which of the following best describes your title?
(% respondents)



Notes

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