



John Greenwood, Invesco Chief Economist

Quarterly Economic Outlook

Second Quarter 2009

OVERVIEW

- The "balance sheet" recessions in the US and the UK as well as other economies of the Eurozone intensified during the past few months from November. Most major economies including Japan and Germany experienced sharply negative GDP growth rates in 2008 Q4, and will see further similar declines in 2009 Q1.
- Export growth and manufacturing production in the emerging economies and especially in Asia were particularly hard hit as consumers cut back abruptly on discretionary spending on durable goods.
- The underlying problem of excessive indebtedness in the household and financial sectors is starting to be addressed, but balance sheet repair is inherently a slow process. Therefore the economic downturn is likely to be prolonged and deep compared with most post-war contractions.
- The policy response in the US and the UK began with interest rate cuts and fiscal spending, but now that official interest rates have almost reached zero, the authorities have moved on to various forms of "Quantitative Easing"(QE) and more focused attempts to deal with the toxic assets held by the banks.
- Central banks in Japan, Switzerland and elsewhere have responded with similar QE programmes.
- The forthcoming G-20 meeting in London will attempt to achieve some consensus on three topics: fiscal stimulus, revised regulation of banking systems, and a resolution to avoid trade, financial or labour protectionism. However, we should not expect more than a broad statement of principles, with perhaps a few specific commitments to do the right thing.
- The hard task is balance sheet repair, and the rebuilding of consumer and business confidence in each economy.
- By far the most important of the initiatives designed to address these issues are the Fed's commencement of Quantitative Easing or Credit Easing, and the US Treasury's plan to deal with the toxic assets of the US banking system.
- Most major economies will remain in recession or at least in relative stagnation through most of 2009. I do not envisage a rapid recovery in the second half of 2009. A modest recovery is possible in 2010, but a slow-growth environment will persist for longer.
- Collapsing demand for commodities, falling production and slowing income growth have together caused inflation to fall abruptly in recent months. Headline inflation rates (which include food and energy prices) will fall further, implying outright deflation in some economies in 2009. Core inflation (which excludes food and energy) will fall to very low levels.
- Corporate debt spreads are at record levels reflecting the stresses of recent forced sales due to de-leveraging. More controversially, they indicate an unimaginably high risk of substantial corporate defaults in the next few quarters.
- With near-zero official interest rates, 2009 and 2010 will see a search for yields by investors.

- *Stock markets have been immensely volatile, because they are in the middle of a tug-of-war between plunging economic activity, falling sales growth and declining profits on the one side and government and central bank rescue and stimulus plans on the other.*

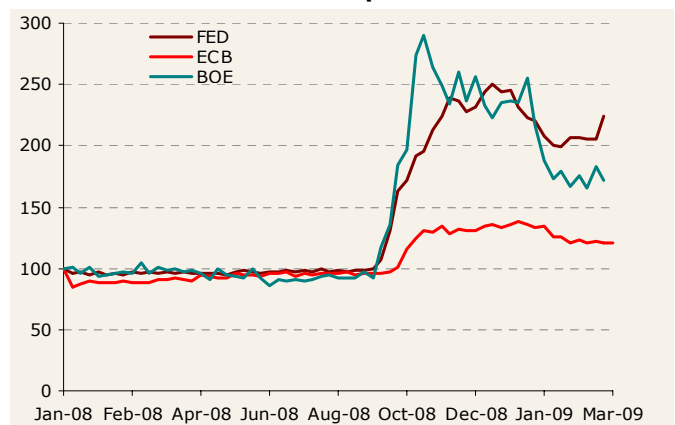
INTRODUCTION

Ever since the credit crisis began in September 2007 the official response has mainly concentrated on treating the symptoms of the crisis, and only in the past six months have the authorities turned their attention to some of the underlying causes. This is understandable because the symptoms of the crisis have included tighter credit and, more recently, sharply reduced spending (both of which appeared to need treating), but also because the nature of this recession is so different from most post-war economic downturns.

Initially the authorities focused on easing credit conditions, trying to lower spreads on inter-bank rates and reduce the cost of borrowing by lowering official interest rates. Essentially this amounted to a traditional approach to recessions -- easing liquidity in the hope that lower rates and cheaper funds would induce credit flows to revive. However, these efforts did not work because despite abrupt reductions in rates, the banks have been unwilling or unable to lend, while consumers and businesses have generally been reluctant to borrow.

Next, starting in October 2008 after the crisis intensified, the authorities in many countries announced support for their banking systems consisting of capital injections, and deposit and debt guarantees, together with big increases in fiscal spending to try to replace reduced private sector spending with increased public sector spending. The basic idea here is that in the equation for GDP (where Y or $GDP = C + I + G$, or Consumption plus Investment plus Government spending), an increase in G will compensate for declines in C or I . However, even this has not prevented economies from entering severe recessions, partly because it takes time for the fiscal spending plans to take effect, but also because the fundamental cause of this recession is more deep-seated than simply due to the drying up of Consumption and Investment spending.

Central Bank Assets Surge Post Lehman Brothers Collapse



Source: Datastream, Local currency units, rebased 3/1/08 = 100



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Finally and most recently we have seen a shift from conventional monetary policies (adjusting interest rates) to unconventional policies (such as quantitative easing) where central banks buy government bonds or corporate securities with a view to driving down the longer end of the yield curve, and policies designed to eliminate the drag from toxic assets on banks' balance sheets. These latter schemes operate either by providing governmental insurance for bad assets (as in the UK), or by setting up public/private co-investment funds to buy "legacy" (or toxic) loans and securities from the banks (as in Treasury Secretary Geithner's Public-Private Investment Program or PPIP).

As we have argued before in these Outlook reports, the fundamental cause of the current economic downturn is to be found in the prolonged build-up of household and financial sector debt in a number of major economies over the past decade or more. Once too much debt has accumulated and the values of the assets purchased with those borrowings are falling, households and financial firms must undertake balance sheet repair. They cannot simply resume spending at normal rates. The problem, of course, is that balance sheet repair is inherently a slow process -- requiring recapitalisation (for banks or other financial firms), the sale of assets and the use of the proceeds to pay down debt, or the gradual payback of debt from income. In this context, since government spending requires funding by additional debt issuance, the net result is that public debt is piled on top of private debt.

Given the scale of the debt created in the past decade it is not surprising that the "balance sheet" recessions in the US and the UK as well as other economies of the eurozone intensified during the past few months following the Lehman bankruptcy and the rescue of AIG in September. Most major economies, notably the big exporting economies of Japan and Germany, experienced sharply negative GDP growth rates in 2008 Q4, and will see further similar declines in 2009 Q1. Export growth and manufacturing production in the emerging economies and especially in Asia were particularly hard hit as consumers in developed economies cut back abruptly on discretionary spending on durables or manufactured goods.

Looking forward it is highly likely that households in the US, the UK as well as Ireland, Spain, Australia and other indebted economies will undergo an extended period of balance sheet retrenchment, reducing their indebtedness by cutting consumption and raising savings with a view to debt repayment. While house prices are falling it is inconceivable that consumers will voluntarily increase their borrowing. This means that household consumption spending is likely to remain subdued at least while house prices continue to fall, leading in turn to falling or weak real GDP growth rates in most economies this year. As the table below indicates, only China and India are expected to register positive real GDP growth rates in 2009.

On the inflation front several major economies including the US and Japan are expected to record outright deflation, or falling consumer prices during 2009, while inflation will be positive but negligible in the eurozone, Canada and China. However, in those economies where exchange rates have weakened sharply such as the UK, Australia and India, inflation rates are expected to continue at much more normal rates.

	2008 Actual		2009 Consensus Forecast	
	Real GDP	CPI Inflation	Real GDP	CPI Inflation
US	1.1%	3.8%	-2.8%	-0.9%
EU-12	0.7%	3.3%	-2.6%	0.6%
UK	0.7%	3.6%	-3.0%	1.0%
Japan	-0.7%	1.4%	-5.8%	-1.1%
Australia	2.1%	4.4%	-0.3%	2.1%
Canada	0.5%	2.4%	-1.8%	0.2%
China	9.0%	5.9%	7.0%	0.2%
India*	6.4%	8.2%	5.2%	5.3%

* Fiscal year data (i.e. FY08 = April 08 to March 09)

UNITED STATES

Real GDP plunged by -6.2% at an annualised rate in 2008 Q4 according to revised estimates. I expect the decline to have persisted at a roughly similar pace in 2009 Q1, and then to moderate in Q2 and Q3, with smaller declines, perhaps recovering to show a small positive growth in Q4. In other words the level of income and output will have fallen sharply in the six months October to March, and then it will gradually stabilise over the balance of the year, but there will be no recovery. Looking further out the consensus forecast of economists is for anaemic growth of 1.7% in 2010, but my forecast is for slower growth at 0.9%.

The key to understanding these developments is to recognise that from April 2008 -- following the rescue of Bear Stearns by JP Morgan and assisted by the Fed -- until September 2008 there was essentially zero growth of money and credit, and then following the bankruptcy of Lehman Brothers, the rescues of Merrill Lynch and AIG, and the closure of Washington Mutual in September there was an absolute decline in credit. Zero growth of credit over six months would have precipitated an economic slowdown, but the heightened credit strains after September drastically affected consumer and business behaviour. This intensification of the credit crunch meant that it was now very difficult for firms and households even to roll over existing obligations, let alone take on new debt. As a result, the combination of tight credit and falling house prices, stock prices and commodity prices all induced rapid de-leveraging by borrowers, as well as sharp cutbacks in expenditure.

These events triggered a series of strong policy responses by the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Treasury, and the Congress. Not only has the Federal Reserve cut interest rates very aggressively -- ultimately to a range of 0-0.25% on 16 December -- but since mid-September it has expanded its balance sheet from \$940 billion to over \$2.2 trillion by means of a series of different lending and acquisition programmes. The Federal Deposit Insurance Corporation (FDIC) has enlarged and extended its deposit guarantees, and offered guarantees to the inter-bank market.

In September the Treasury proposed and in October the Congress eventually passed the TARP (Troubled Asset Relief program), a \$700 billion scheme originally to buy illiquid, hard-to-value mortgage-backed securities and other toxic assets from financial institutions. However the intention to purchase these bad assets was soon abandoned in favour of redirecting the bulk of the funds to bank recapitalisation. In addition the newly elected President Obama introduced a fiscal stimulus plan of \$787 billion, enacted on 17 February, even though this may lead to a record-breaking budget deficit in excess of \$1 trillion. Calling it "the most sweeping



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recovery package in US history," Obama aims to save or create 3.5 million jobs, boost consumer spending, and rebuild the country's crumbling infrastructure.

Stimulus Packages as % of GDP

	2008	2009	2010	Total
Canada	0.0%	1.5%	1.3%	2.7%
France	0.0%	0.7%	0.7%	1.3%
Germany	0.0%	1.5%	2.0%	3.4%
India	0.0%	0.5%	-	0.5%
Italy	0.0%	0.2%	0.1%	0.3%
Japan	0.4%	1.4%	0.4%	2.2%
UK	0.2%	1.4%	-0.1%	1.5%
US	1.1%	2.0%	1.8%	4.8%

Source: The Economist

On 19 February President Obama announced two schemes called the Homeowner Affordability & Stability Plan with a combined value of \$75 billion designed to prevent up to 9 million homeowners going into foreclosure. The first scheme is targeted at about 5 million troubled borrowers classified as responsible homeowners. The plan differs from the foreclosure schemes of the previous administration in its focus on borrowers who are current in their mortgage payments but are in danger of default and it uses incentives to encourage mortgage lenders to work out loan modifications.

Another scheme, called Homeowners Stability Initiative, aims to help another 4 million borrowers. This will limit monthly payments to 31% of a borrower's monthly income. The plan will pay \$1,000 for every loan modification, plus another \$1,000 per year for 3 years if the homeowner remains current with payments. There are other incentives to mortgage lenders, service companies and borrowers. It has to be said that while the scheme is genuinely attempting to deal with one of the real causes of the crisis (householders' excessive debt), groups of responsible homeowners across the country have expressed outrage at the anti-foreclosure plan. They charge that Obama and his advisers are using the tax payments of responsible mortgage borrowers to pay the mortgages of irresponsible people. Some also say that the plan ignores the needs of Americans who have lost their properties to foreclosures that occur for other reasons (e.g. non-payment of tax).

Finally and most recently, Treasury Secretary Geithner announced a scheme to deal with the bad assets on the books of the banks – another attempt to get to grips with one of the real causes of the crisis. The Public-Private Investment Program (PPIP) proposes to use a combination of public sector and private sector funds to buy the bad assets (loans and securities) of the banks, relieving them of their problem assets and enabling them to clean up their balance sheets. The plan has several potential short-comings:

- First, it depends critically on the ability of the private sector portfolio managers to create an active and realistically priced market for the impaired assets of the banks – something that Mr Paulson's TARP previously abandoned. This was also one of the stumbling blocks in the Japanese bank rescue schemes of the 1990s.
- Second, the funds that are used to buy toxic assets from the banks will mostly be coming from or guaranteed by the public sector (the Fed, the Treasury and the FDIC), and -- insofar as they are

loaned at subsidised rates -- could well result in further resentment directed both towards the favoured asset managers and the Administration itself.

- Third, there must be a large element of doubt about the willingness of banks to sell their assets at what may be very low prices, thus crystallising further losses. Again, this was something that stalled Japanese bank restructuring ten years ago.
- And fourthly, will the amounts proposed -- \$500 billion rising potentially to \$1 trillion – be sufficient to deal with banks' toxic assets once and for all? Based on the size of US domestic commercial banks' assets (\$10.6 trillion, of which \$6.4 trillion is loans and \$2.2 trillion is securities), the losses still to show up could yet exceed \$1 trillion. This is presumably what Mr. Geithner's stress tests, due by the end of April, are designed to reveal.

Can this plethora of plans offset the decline in private sector spending? The brief answer is probably not in 2009. The problem is that Federal spending programmes and central bank lending schemes depend for their effectiveness on the willingness of consumers and businesses to use the federal funding for new expenditures, and on banks to lend or invest the new central bank cash injections. However, if the priority for consumers and businesses is to restore sound balance sheets by repaying debt (not taking on more debt), then the standard fiscal and monetary "multipliers" will not work. That in turn implies that recovery may not come until household and financial sector balance sheets have been at least partially repaired. Consequently it may take until 2010 for more normal spending patterns to resume.

The upside of this otherwise gloomy outlook is that inflation will remain low (and possibly even register mild deflation) as long as unemployment and excess capacity continue to rise. In this environment, interest rates (for federal funds and treasury bills and bonds) will stay low for an extended period, despite the large funding needs of the federal government. In time the weakness of the economy should be reflected in weak credit demand, and this should flow through to corporate credit, providing a favourable backdrop for fixed income investment.

EUROZONE

Real GDP in the eurozone declined steeply by -1.5% quarter-on-quarter (or -6.1% annualised) in 2008 Q4, driven by sharp declines in investment and exports. Germany's real GDP declined by -2.1% (-8.7% annualised), while those of France -1.2% (-4.9% annualised) and Italy -1.9% (-7.8% annualised) also declined, driven by similar factors. Germany's exports represent over 50% of GDP and are expected to continue to weaken during the year, with little or no offset from domestic demand. The IFO survey of business confidence plunged between May and December, but has continued to remain at its lowest levels in the first three months of 2009. These figures demonstrate the eurozone's acute sensitivity as a major exporter to the weakness in world trade. In addition tighter credit, negative wealth effects from past falls in the stock market and weaker home prices, together with the ECB's relative slowness to cut interest rates, all add up to the prospect of further economic weakness ahead with falling inflation. This is confirmed by the sharp fall in the February and March PMI surveys



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German Ifo remains at record lows



Source: Bloomberg

We expect real GDP in the eurozone to fall by -3.1% over 2009 as a whole (lower than consensus), and then to recover to +1.3% growth in 2010. Weaker commodity prices and the emergence of substantial excess capacity will dampen inflationary pressures. We therefore expect the CPI to fall from 3.3% in 2008 to 0.6% in 2009, and then to move up again to 1.6% in 2010. With inflationary pressures already easing, there is scope for the ECB to cut rates further below the 1.5% set on 11 March. Nevertheless, the economy is likely to remain in recession for most of 2009. In response to the recession, tax revenues have fallen and with the announcement of emergency fiscal spending plans, most eurozone governments will see substantial increases in their budget deficits. This in turn has caused spreads on the bonds of the weaker member countries to widen. However, despite these stresses we do not expect any eurozone economy to secede from the currency union.

UNITED KINGDOM

Following a decline of -0.7% in Q3, the UK's real GDP declined by -1.6% (-6.6% annualised) in 2008 Q4, with gross fixed capital formation (investment) falling -1.4% (-5.7% annualised), output of production industries falling -4.5% (-19.3% annualised), and service sector output falling by -0.8% (-3.2% annualised), and construction falling -4.9% (-21.1% annualised), while exports in real terms fell by -3.9% (-16.5% annualised). The sharp deterioration continued into the first quarter of 2009 with businesses and households both being hit by tight credit and weakening demand. Indicators of consumer confidence have fallen to very low levels as unemployment increased steeply to 4.3% (or 6.5% on the ILO basis), while job vacancies fell to a record low level in February. Continued falls in house prices, which declined by 17.7% year-on-year in February according to the Halifax index, and worsening employment prospects are undermining consumers' willingness to spend on big-ticket items, reflected in the rise of the savings rate to 4.8% in Q4. Declines in house prices and the stock market mean that approximately £1.9 trillion has been wiped off household's balance sheets. This was reflected in retail sales which fell -1.9% in February, and will constrain consumer spending going forward. Our view is that the UK economy will contract by -2.9% in 2009, and inflation on the CPI measure will rise by only 1.2% (avoiding deflation mainly due to the weakness of sterling).

In response to this dismal economic performance the authorities have taken further measures to try to offset the downturn. At each MPC meeting in January, February and March the Bank of England cut Bank Rate by 0.5%, from 2.0% in December to 0.5% in March. Also in March they simultaneously announced they would implement a new Asset Purchase Facility – which amounts to a policy of Quantitative Easing -- by buying up to £75 billion of gilts and corporate bonds (and a further possible £75 billion of corporate debt) in a series of reverse auctions. This is in addition to the Special Liquidity Scheme, the Term Auctions and other measures previously introduced. In addition, the authorities have offered an Asset Protection Scheme to banks to enable them to insure some of their bad assets with the authorities. For a fee, the Treasury will provide protection against the majority of credit losses exceeding a 'first loss' amount, with the participating institution covering the residual exposure, likely to be in the region of 10%. Following the G-20 meeting in early April it is likely that the (delayed) Budget will contain further support measures for the economy.

However, the lesson of Japan between 1990 and 2006 is that the transmission of government spending or monetary stimulus to the rest of the economy depends on the willingness of the private sector to spend or take on more debt. From a starting position as one of the most heavily indebted household sectors in Europe, it is hard to see how the UK householder will quickly regain an appetite for more debt and hence vigorous spending. This means that growth may not recover until 2010 or beyond. Meantime, unemployment is likely to rise further. Nevertheless, subject to the level of sterling, inflation should remain low, reflecting falls in energy and other commodity prices and the build-up of spare capacity.

JAPAN

Japan has been hit harder in the current downturn than almost any other major economy due to its large dependence on exports combined with its pre-existing weak domestic demand which has been unable to provide any counterbalance to the global downturn. All of this was exacerbated in the early stages of the downturn by the strength of the yen resulting from the unwinding of the yen carry-trade. Consequently in 2008 Q4 real GDP declined by an extraordinary -3.2% quarter-on-quarter (-12.1% annualised), with exports of good and services falling in real terms by -13.8% (q-o-q). Subsequently Japanese exports on a customs clearance basis have fallen by an astonishing -45.7% in January and -49.4% in February. Along with these catastrophic declines, industrial production has plunged, inventories have surged, and the labour market has weakened sharply especially among part-time employees (where most of the growth has been in recent years).

I expect Japan's GDP to decline through most of 2009, and any recovery in 2010 to be dependent on external stimulus, but yen strength will be a severe handicap in orchestrating a recovery. Japan has already relapsed into deflation, and this is likely to continue during the next two years. To counteract the tsunami of bad economic data the Japanese government has announced new fiscal spending plans to try to stimulate growth, and the Bank of Japan has lowered its target rate to 0.1% on 19 December. Like the Bank of England and the Federal Reserve they are again embarking on Quantitative



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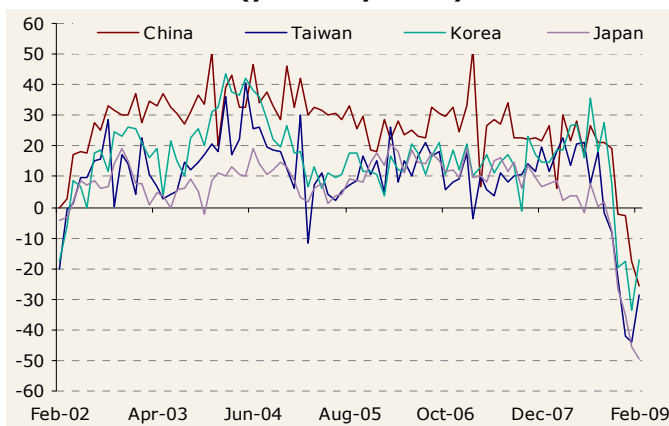
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Easing by buying more Japanese government bonds (JGBs), corporate bonds and commercial paper. On this occasion consumers and non-financial companies in Japan are less leveraged than they were during the 2001-06 episode of QE, so the transmission mechanism should be more effective. However, Japan will struggle to see a self-sustaining recovery as long as it remains so dependent on external demand.

NON-JAPAN ASIA

Like Japan the export-oriented economies of East Asia have seen their exports fall off a cliff, and real GDP growth plunge into deeply negative territory. Korea's exports plunged in November and December, and continued falling in January (-33.8%) and February (-17.1%) in US\$ terms. (All figures on a year-on-year basis.) Similarly Taiwan's exports fell -44.1% in January and 28.6% in February. China, being further downstream in the Asian supply chain, has suffered slightly less, but exports fell-17.5% in January and -25.7% in February. These figures, replicated across the region, are dramatic evidence of the sharp downturn in world trade as a result of the prolonged credit crunch and its intensification in the wake of the failure of Lehman Brothers.

Asian Exports Decline at Alarming Rate (year-on-year %)



Source: Bloomberg

The collapse of Asian exports emphasises how dependent the East Asian economies are on final demand in the richer OECD economies. Despite the fact that Asian economies export heavily to China and China has become the largest trading partner for some economies in Asia, when the data are adjusted for the portion of trade that is re-exported from China, the OECD economies continue to be the major source of final demand. In turn this implies that domestic stimulus programmes in Asia are unlikely to do much to alleviate the impact of the global downturn. Real GDP in 2009 will be deeply negative across the region, and inflation will fall sharply, possibly even reverting to deflation in 2010 in some cases such as China, Taiwan and Hong Kong.

LATIN AMERICA

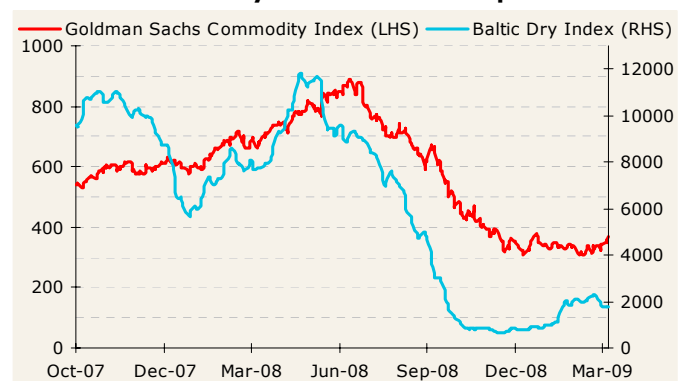
Most of Latin America benefited from strong commodity prices in 2008, and Brazil's boom extended longer than most. However the outlook for 2009 is much more subdued as commodity prices have fallen sharply and overseas demand for manufactured goods has weakened. In contrast to earlier decades Latin America generally entered the global downturn with its external accounts in better shape, although like other

emerging economies the region has been vulnerable to substantial portfolio outflows. We expect growth and inflation to slow in 2009.

COMMODITIES

Since peaking last summer, commodity price movements have for the most part reflected the abrupt decline in global economic growth prospects. However, during the first quarter of 2009, there has been a broader range of outcomes for different commodities. While precious metals have made good gains during the first quarter, agricultural commodities have delivered more muted returns. Copper was one of the leading base metals, supported by a surge in Chinese import demand thanks to government stock-piling. In addition the Baltic Dry Freight index, a good proxy indicator for world trade, has risen, again from an oversold level, but remains 85% below its highs of last May. Similarly with most other commodities, the rally so far in 2009 (albeit from a very low base) leaves prices still considerably below the peaks achieved in the summer of 2008. How sustainable the current revival is, is very much open to debate.

Commodity Prices Remain Depressed



Source: Bloomberg

My expectation is that the price of oil, soft commodities and base metals will remain subdued through 2009 as the recessionary environment keeps a lid on global demand, and hence the current rallies appear unsustainable. The exception is the demand for gold and other precious metals -- regarded as safe-havens against inflation, collapsing banking systems, depreciating currencies or sovereign government defaults. These have remained firm, and prices have also risen during the first quarter. While financial stresses continue to plague the major banking systems of the world there is scope for further upside, but as detailed in this outlook, my view of a prevailing deflationary environment implies that demand for precious metals will eventually weaken.

CONCLUSION

As I concluded in my previous Outlook, 2009 will be a year of recession and rising unemployment across most developed economies, and slowing growth in many emerging economies. The convulsions of the global credit crunch over the past eighteen months have demonstrated that the world needs a much better managed monetary and credit cycle in the future, but those monetary and regulatory changes are being pushed aside for the moment in favour of drastic monetary and fiscal expansion plans in an attempt to grapple with the immediate crisis.



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The critical issue is whether these aggressive expansion plans can succeed in restoring stable and sustainable economic growth without creating new problems of inflation and currency depreciation. The hard truth is that the household and financial sector balance sheet problems created by excessive borrowing during the past decade cannot be wished away by newly devised government spending plans, or by easy money. In previous "normal" recessions the appetite to borrow and spend could usually be revived by rate cuts and fiscal stimulus, but on this occasion the indebtedness of households and financial institutions in the US, the UK and elsewhere is such that the appetite to borrow and spend is unlikely to revive until their respective balance sheets have been repaired. While governments and central banks can help with bank balance sheet repair by capital injections and partial or temporary nationalisation, there is little they can do -- short of debt forgiveness -- to repair household balance sheets. Consequently, sustainable economic recovery will depend more on the household sector sorting out its balance sheet problems than the public sector adding more debt to the already excessive pile.

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27 March 2009

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