World Outlook – a Tale of D and E

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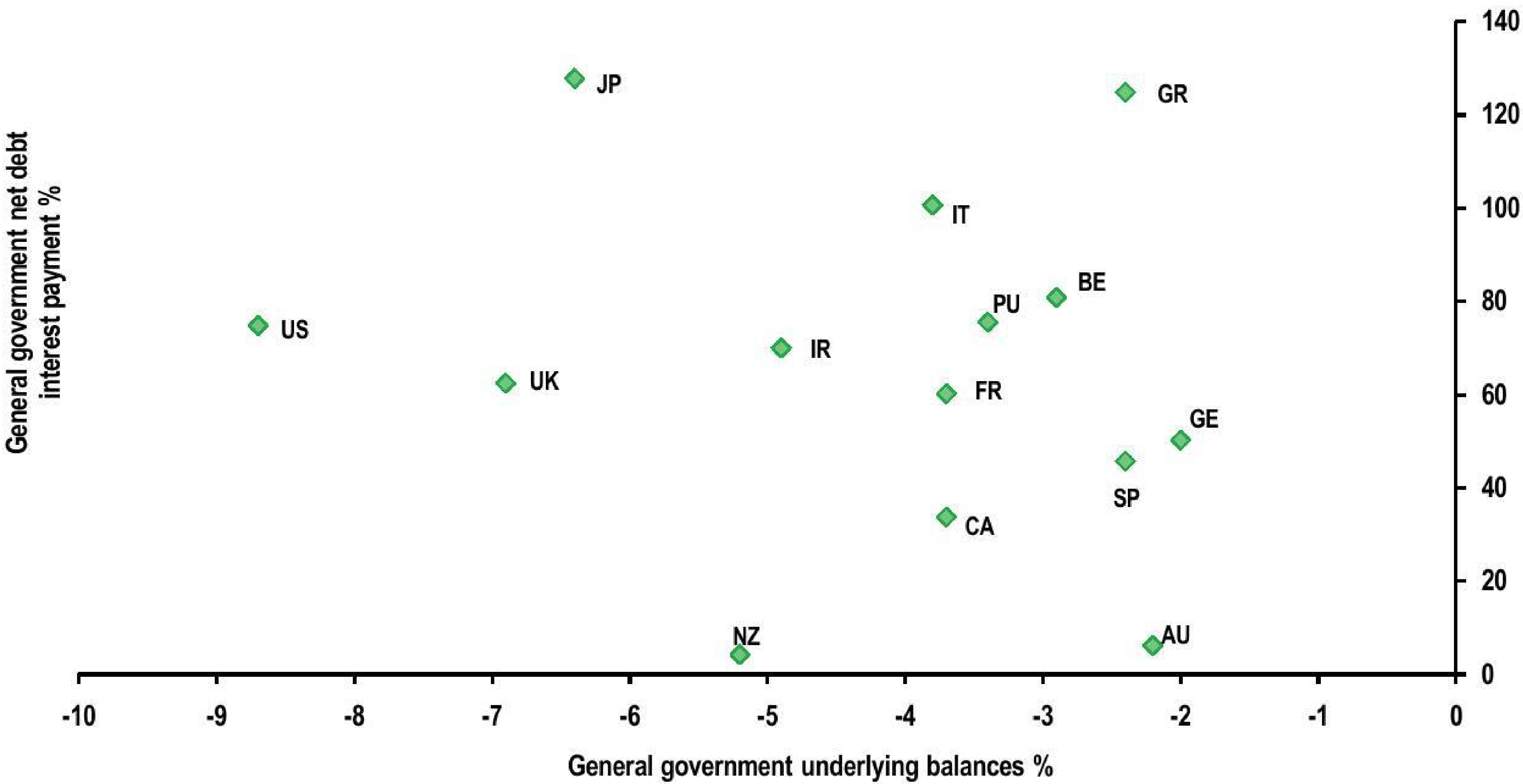
Developed versus Emerging

- Developed countries
  - Debt
  - Deleveraging
  - Deflation
  - (Political) Deadlock
- Emerging countries
  - Expansion
  - Empowerment
  - Excitement
  - Exuberance
- So - Who will lead the way?
  - Developed countries' problems could lead to a depression
  - Emerging countries' growth leads us to the Economic Super-cycle
  - It may take a little time, but our bet is on the Super-cycle

D for debt, deleveraging, deflation and deadlock

Developed country debts and deficits

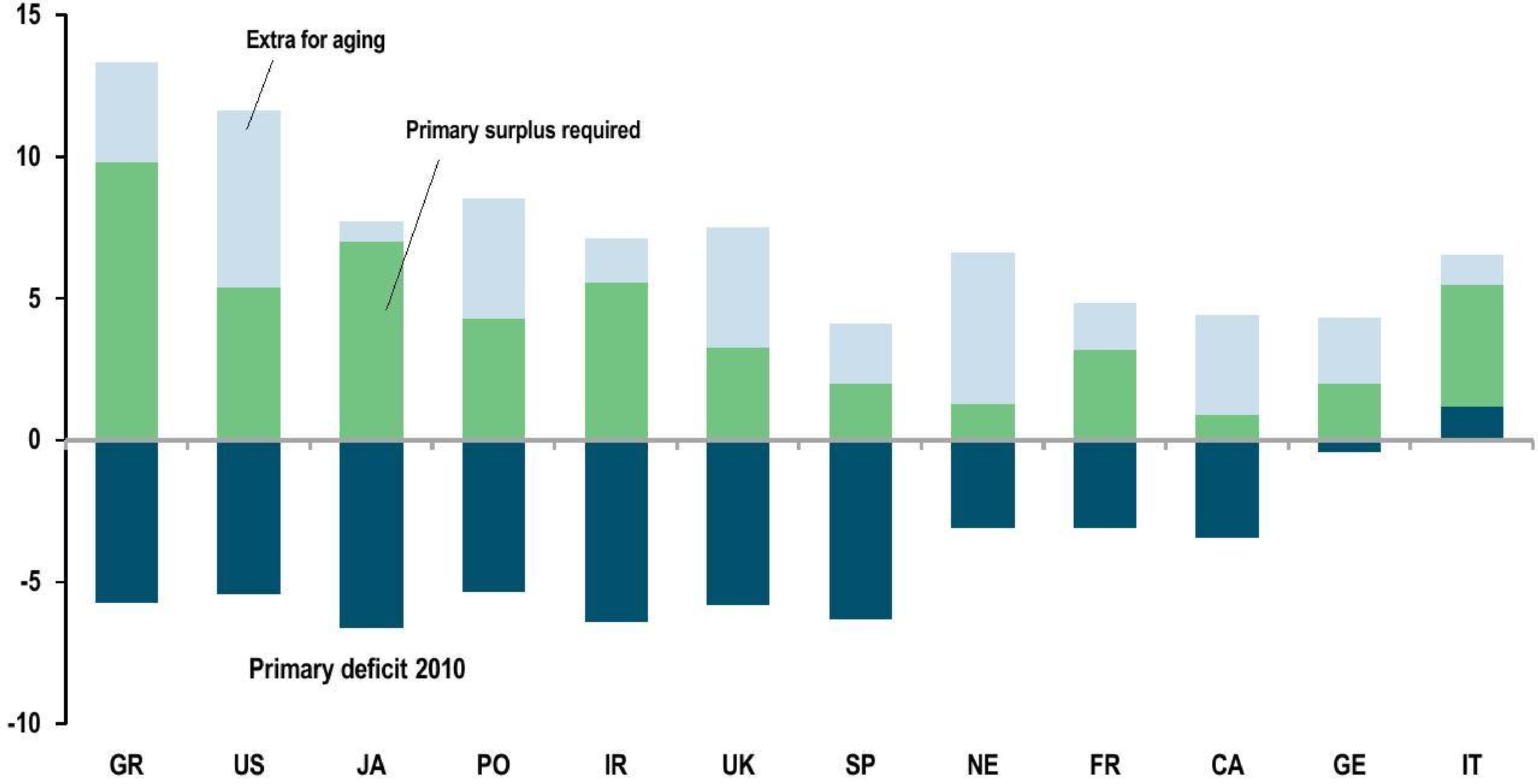
Net debt/GDP versus OECD 'underlying balance' 2011 (adjusted for the cycle)



Sources: OECD, Standard Chartered Research

Huge fiscal adjustments needed

The size of the block indicates the IMF's estimate of the improvement required in the underlying primary balance; i.e. , before interest payments, to stabilise debt at 60% of GDP long-term (% *of GDP*)

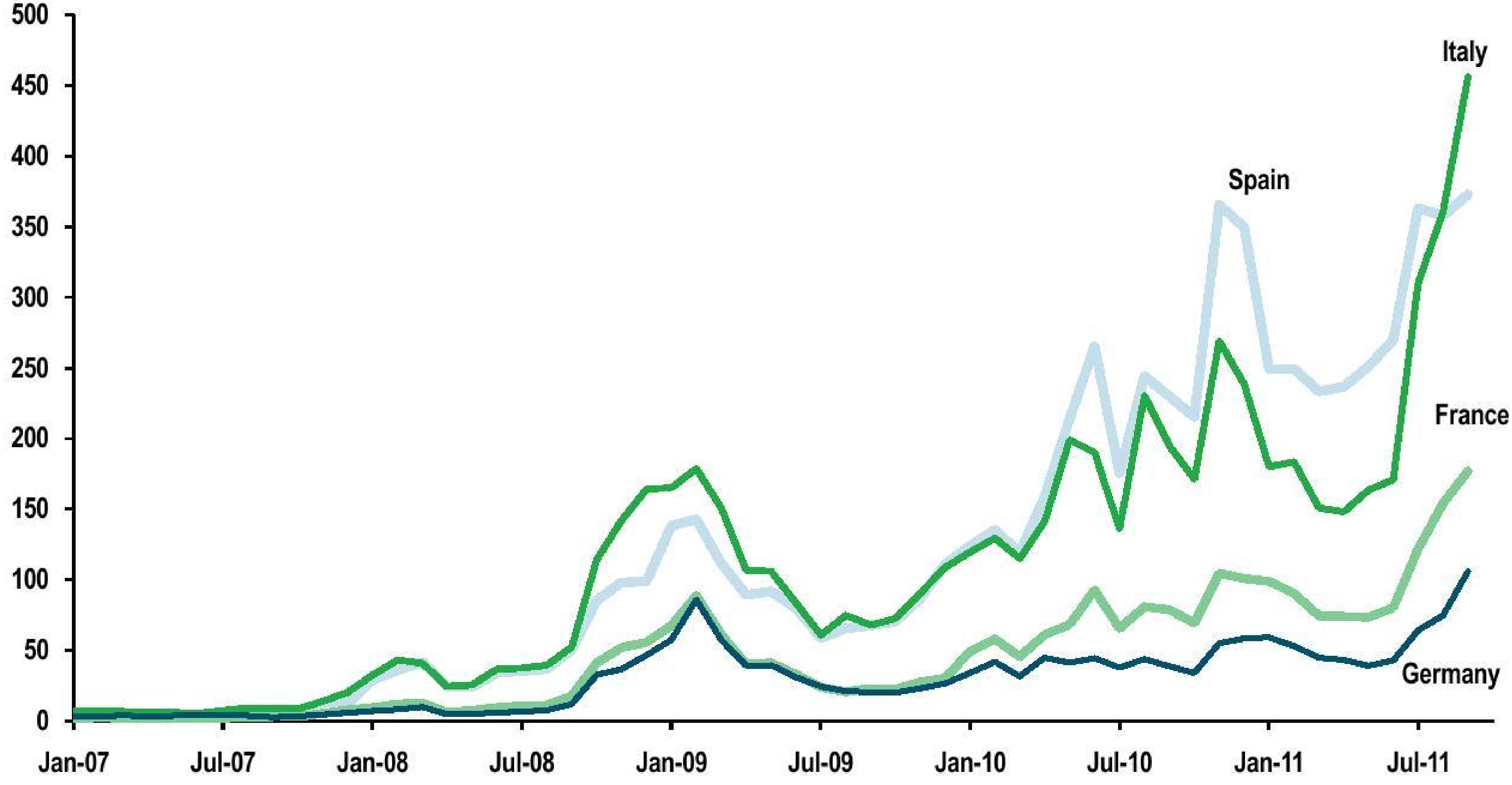


The euro area has a sovereign, bank and political crisis

- Greece and Italy are key
  - Greece needs at least 50% forgiveness
  - Italy has slow growth, high debt and a weak government
  - Portugal is small, Ireland and Spain are adjusting fast
- Banks need help
  - Capital ratios are low and now threatened by losses
  - Long-term funding markets dead
  - Banks in problem countries depend on ECB funding but good collateral is limited
- The euro was always a political project, but how much is Germany prepared to risk?
  - Germany and ECB insist on keeping up the pressure on Greece and Italy
  - Greece and Italy struggling to reform
  - Europe not ready for full fiscal union - hence the muddling through

Surging CDS spreads

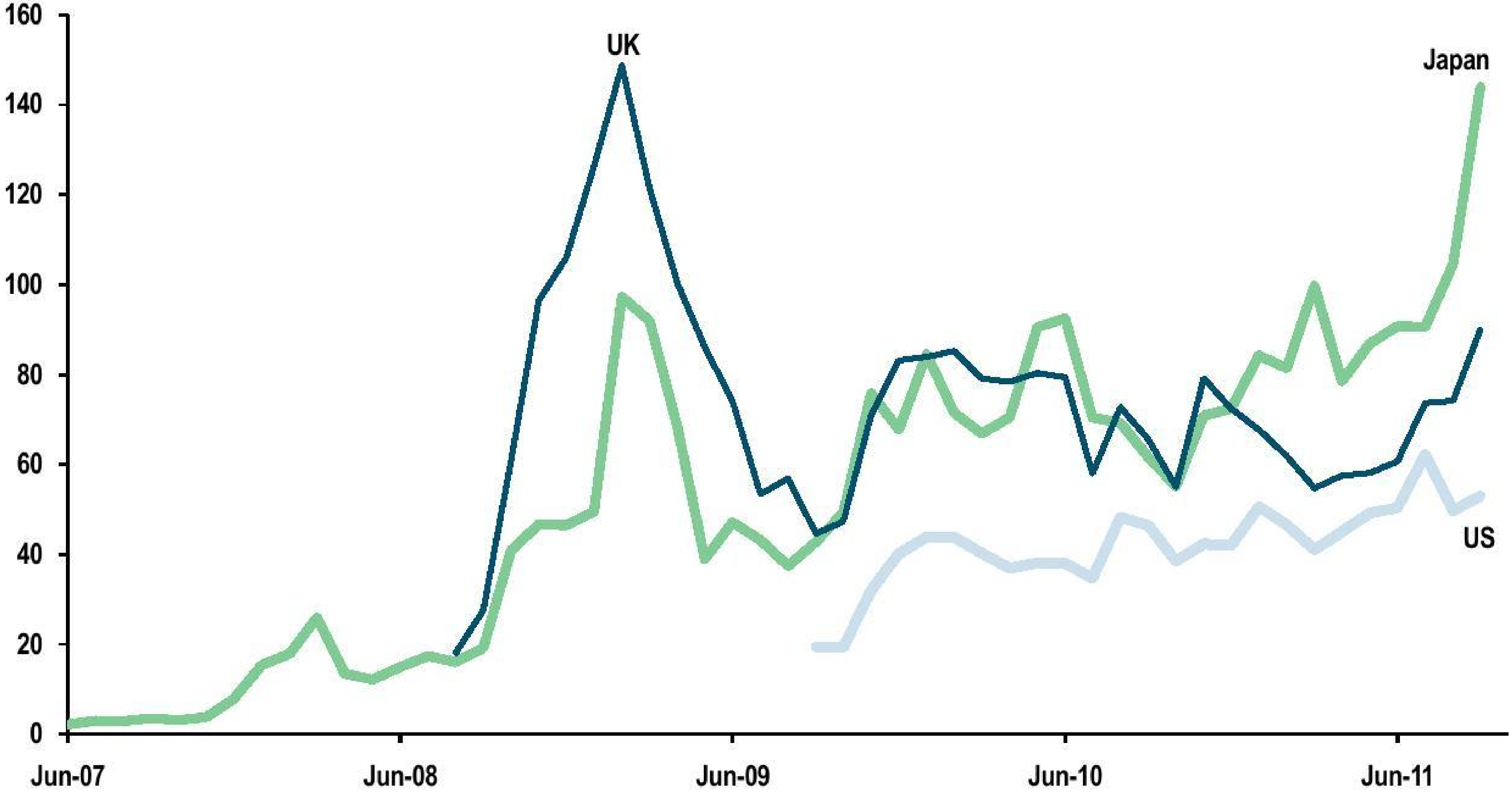
CDS spreads in Europe have surged *(credit default swaps, USD senior 5Y)*



Sources: Bloomberg, Standard Chartered Research

Other countries rising too – Watch Japan

CDS has risen in other developed countries *(CDS USD senior 5Y, EUR for United States)*



Sources: Bloomberg, Standard Chartered Research

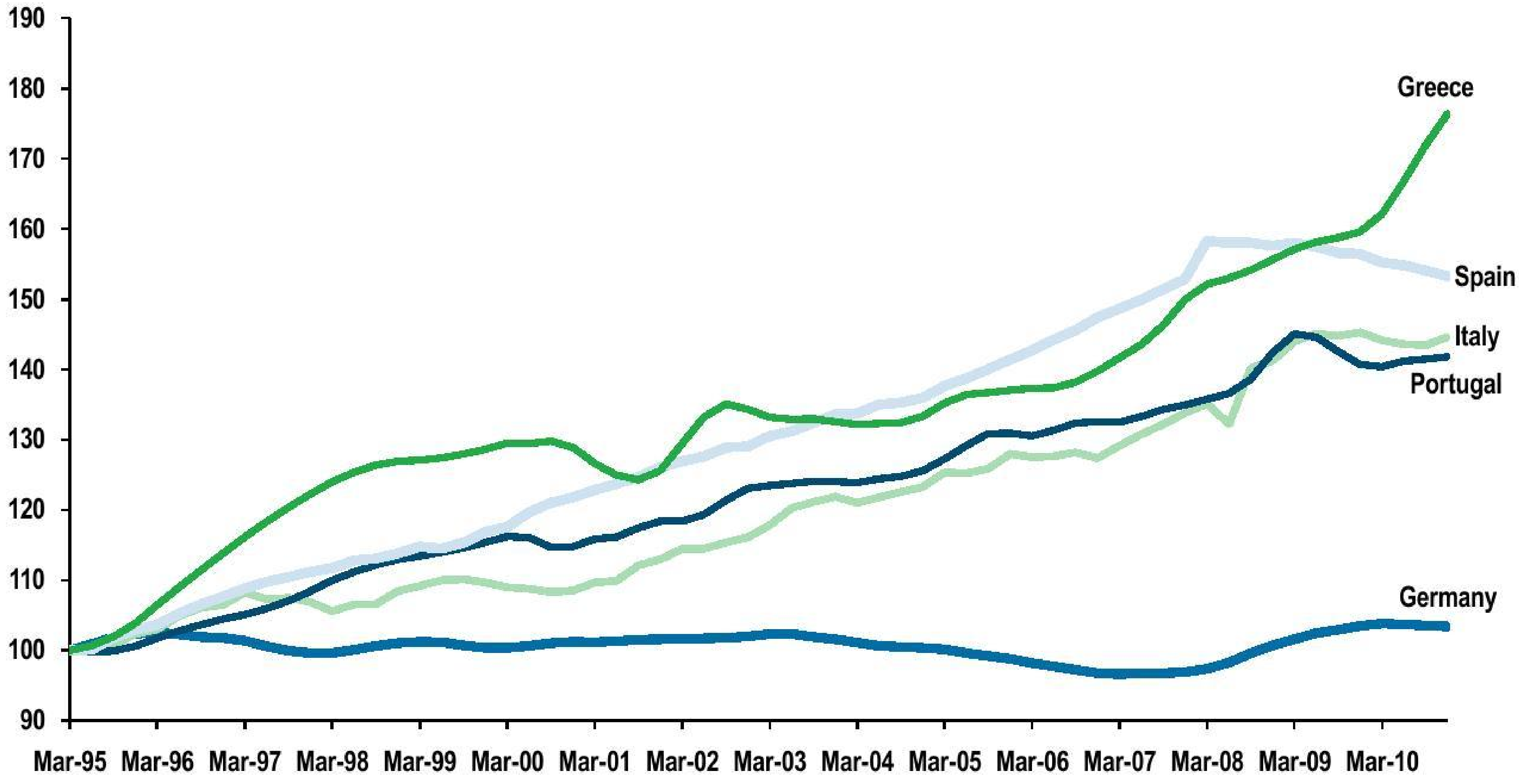
What to look for in Europe as the new package unfolds

There is no magic bullet, but major new measures are coming through

- Sovereigns
  - Greece adjustment stays on track, just
  - More reforms in Italy and Spain
- Banks
  - More capital probably from national governments, maybe the EFSF too
  - Guarantees, etc., to support long-term funding
- New money and/or commitment to help sovereigns
  - Leveraging of EFSF
  - New IMF facility or money?
  - ECB agrees to keep buying sovereign bonds?

Weak sovereigns face a serious competitiveness problem

Unit labour costs in the business sector



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Sources: Bloomberg, Standard Chartered Research

Europe – Possible outcomes

- Muddling through
  - Banks get enough support to keep lending
  - Sovereign borrowing costs held down by EFSF and ECB
  - Sovereigns adjust enough – likely involving deflation
  - Major European recession avoided
  - Haircuts confined to Greece. Italy and Spain prove their solvency
- Weak countries exit euro
  - Germany and the core remain
  - Losses on Greek and other sovereign debt require massive new bank recapitalisation
  - The leavers devalue and eventually restore growth
  - European recession inevitable unless only Greece leaves – hard to achieve
  - Bank runs would put huge pressure on Portugal, Spain, Italy
  - New world recession probably inevitable too

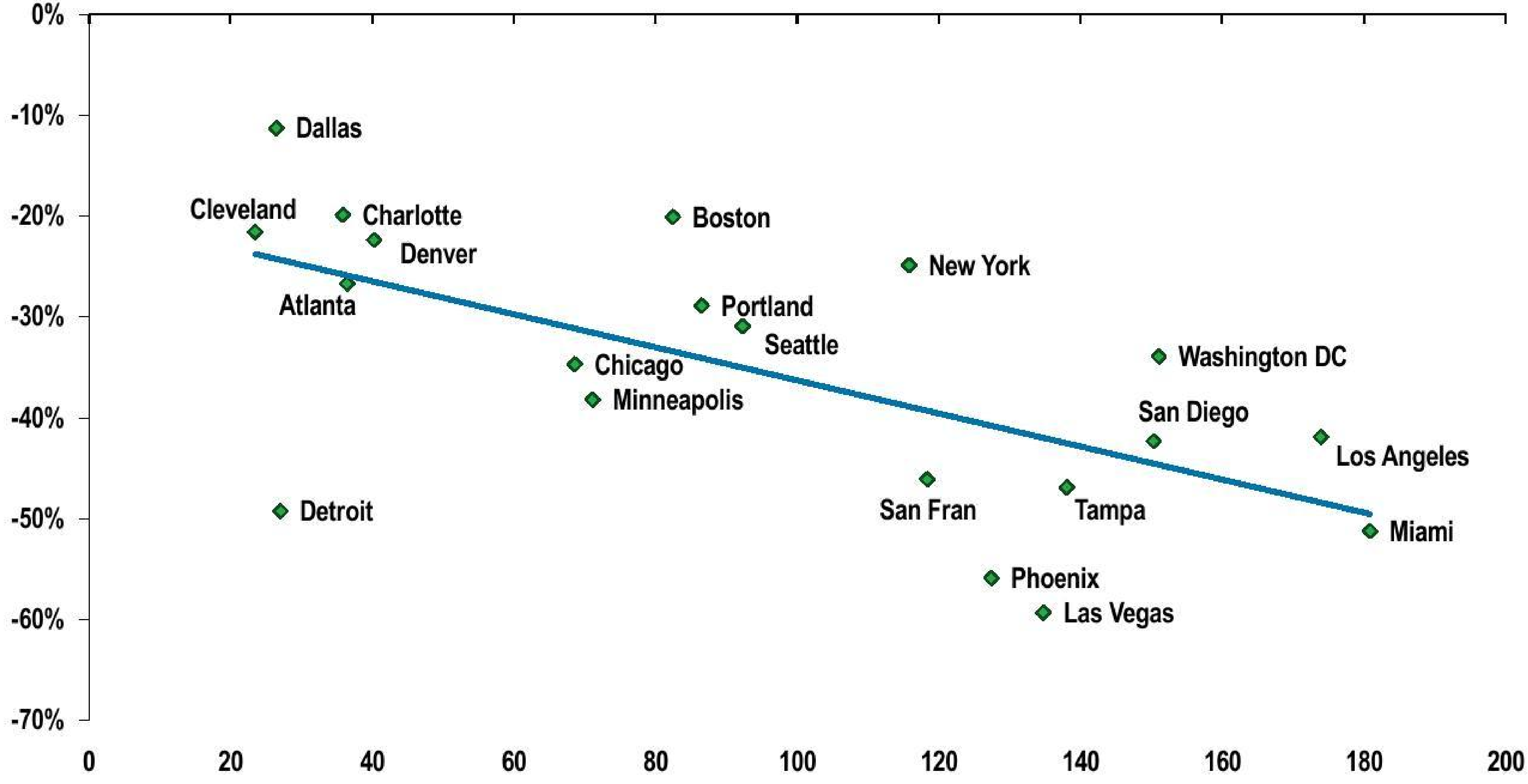
Deleveraging – US households working down debt

The case for continued deleveraging is strong . . . And it may last for years to come

Sources: Bloomberg, Standard Chartered Research

US housing bubble – Price moves by city

X-axis is the peak in prices since 2000. Y is the maximum decline from the peak.



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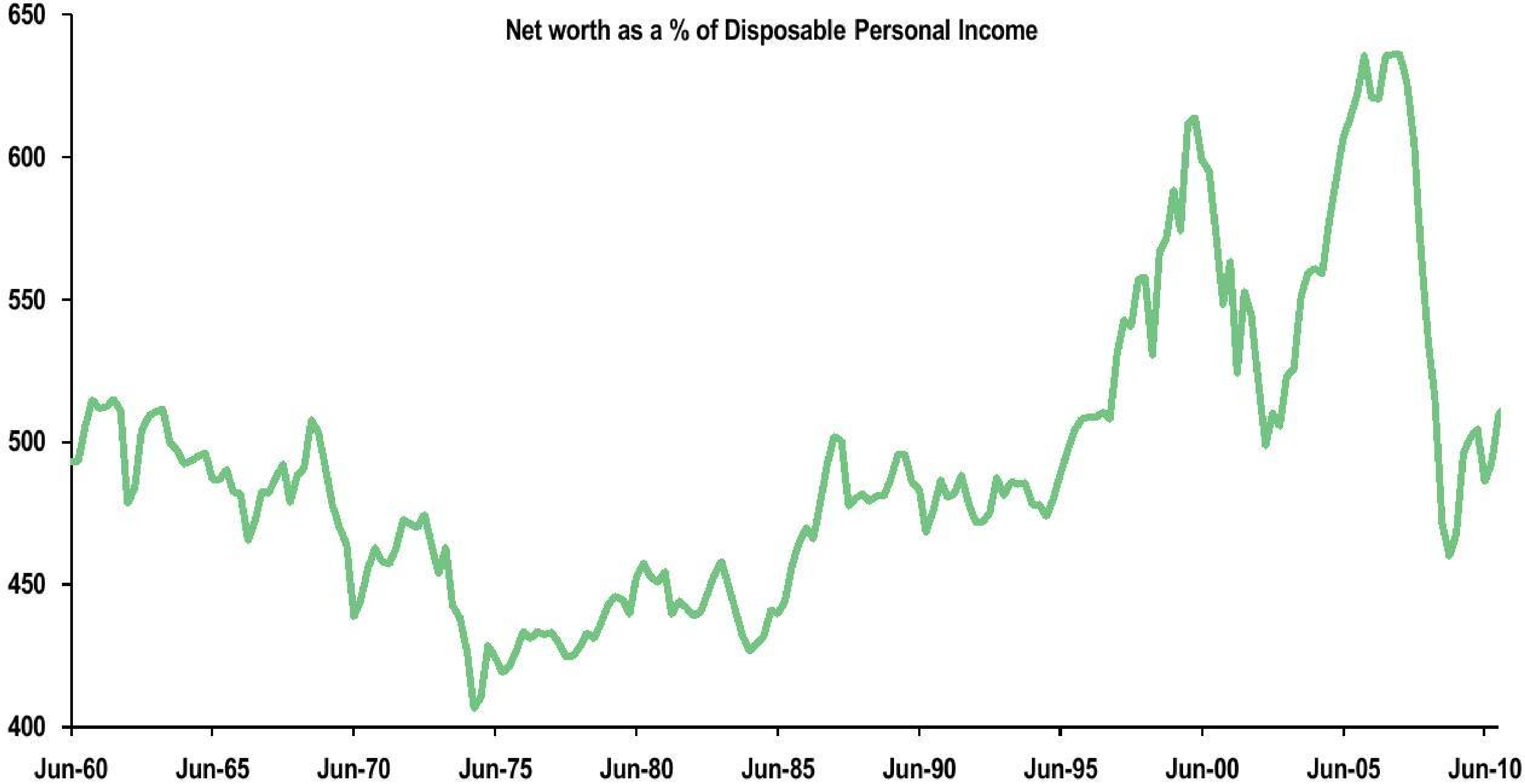
Sources: Bloomberg, Standard Chartered Research

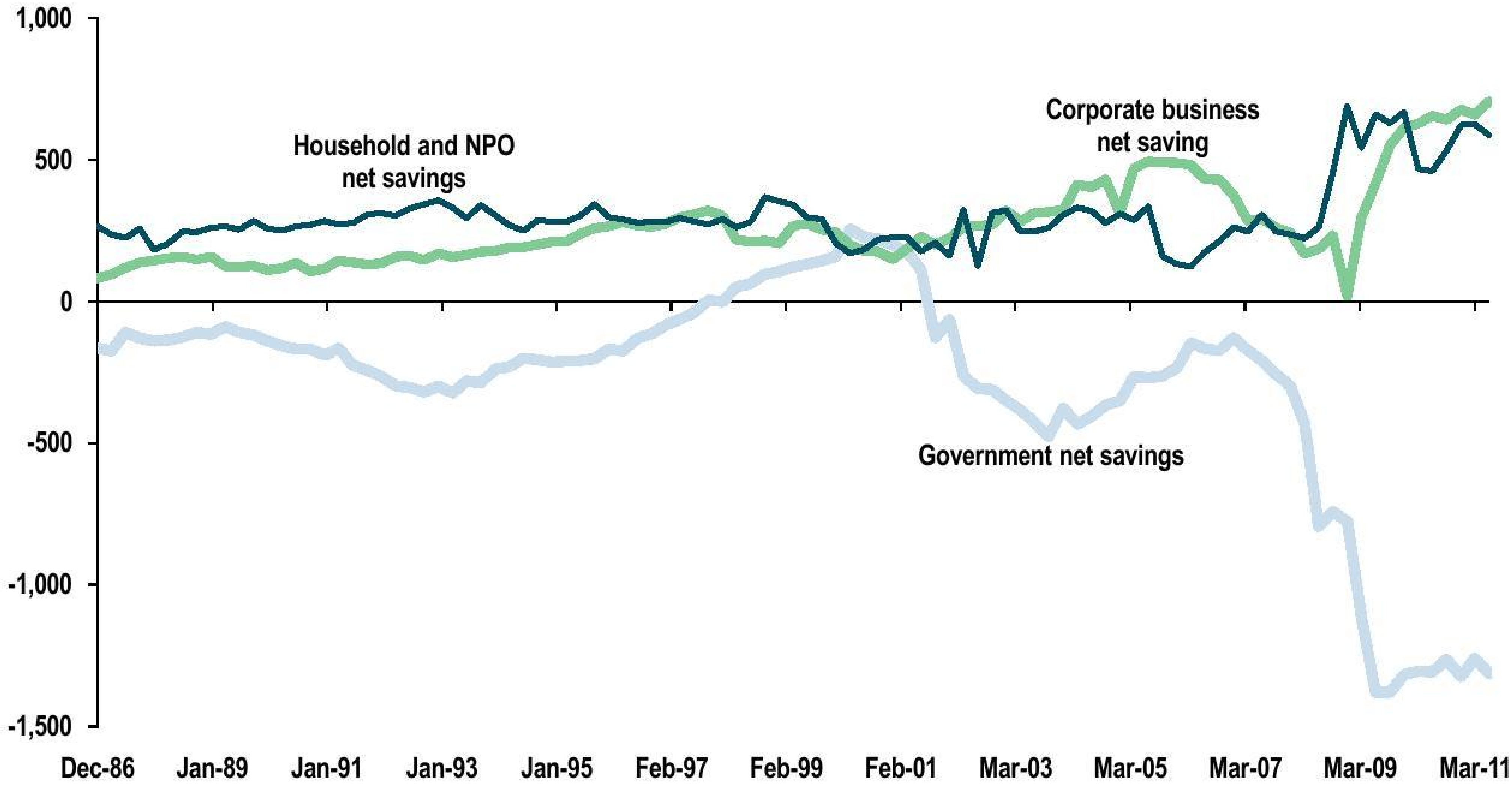
US household wealth as % of disposable income

Overall wealth is back to more 'normal' long-term levels



US households and businesses are saving hard

Corporate and personal savings are offset by government borrowing *(USD bn)*



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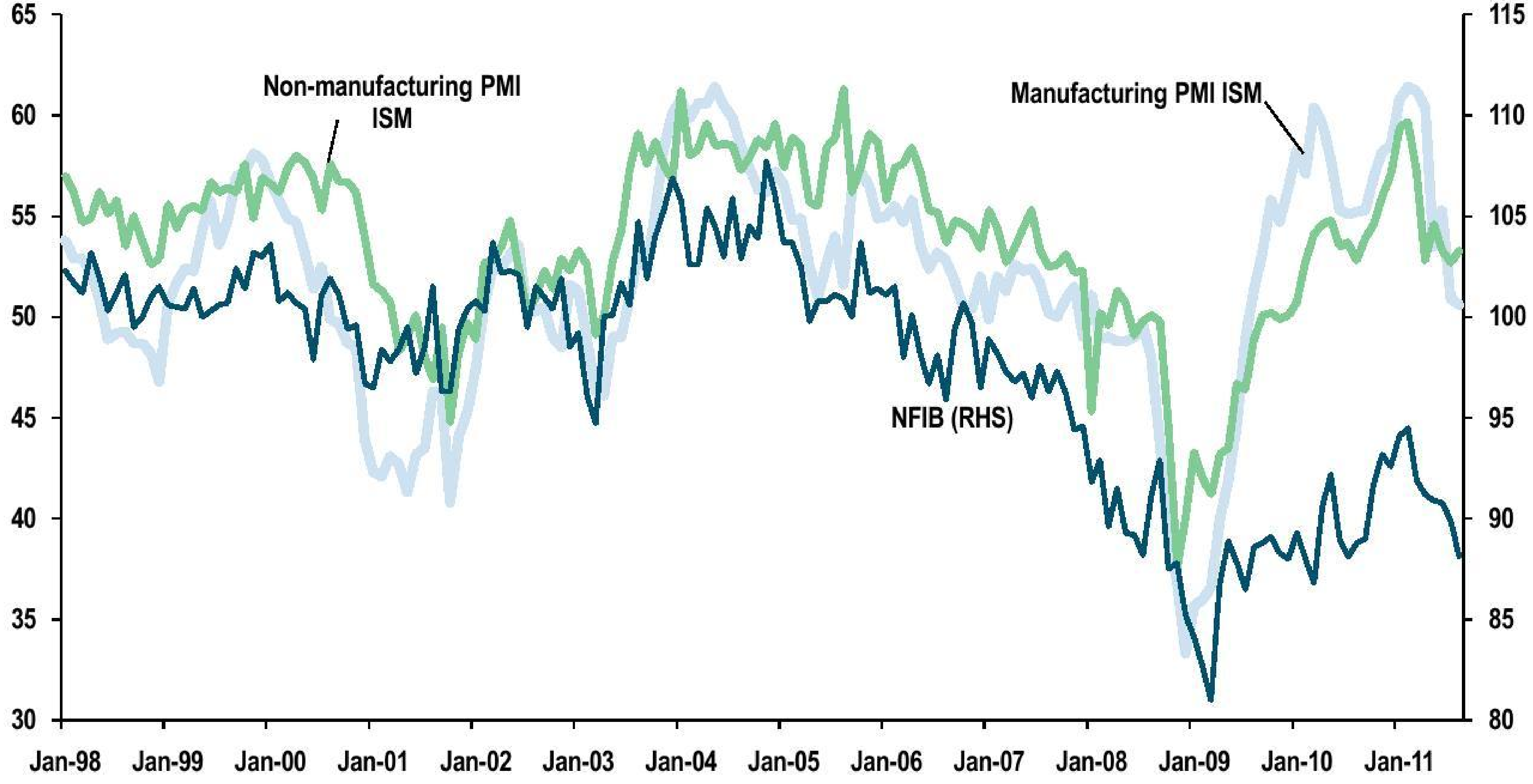
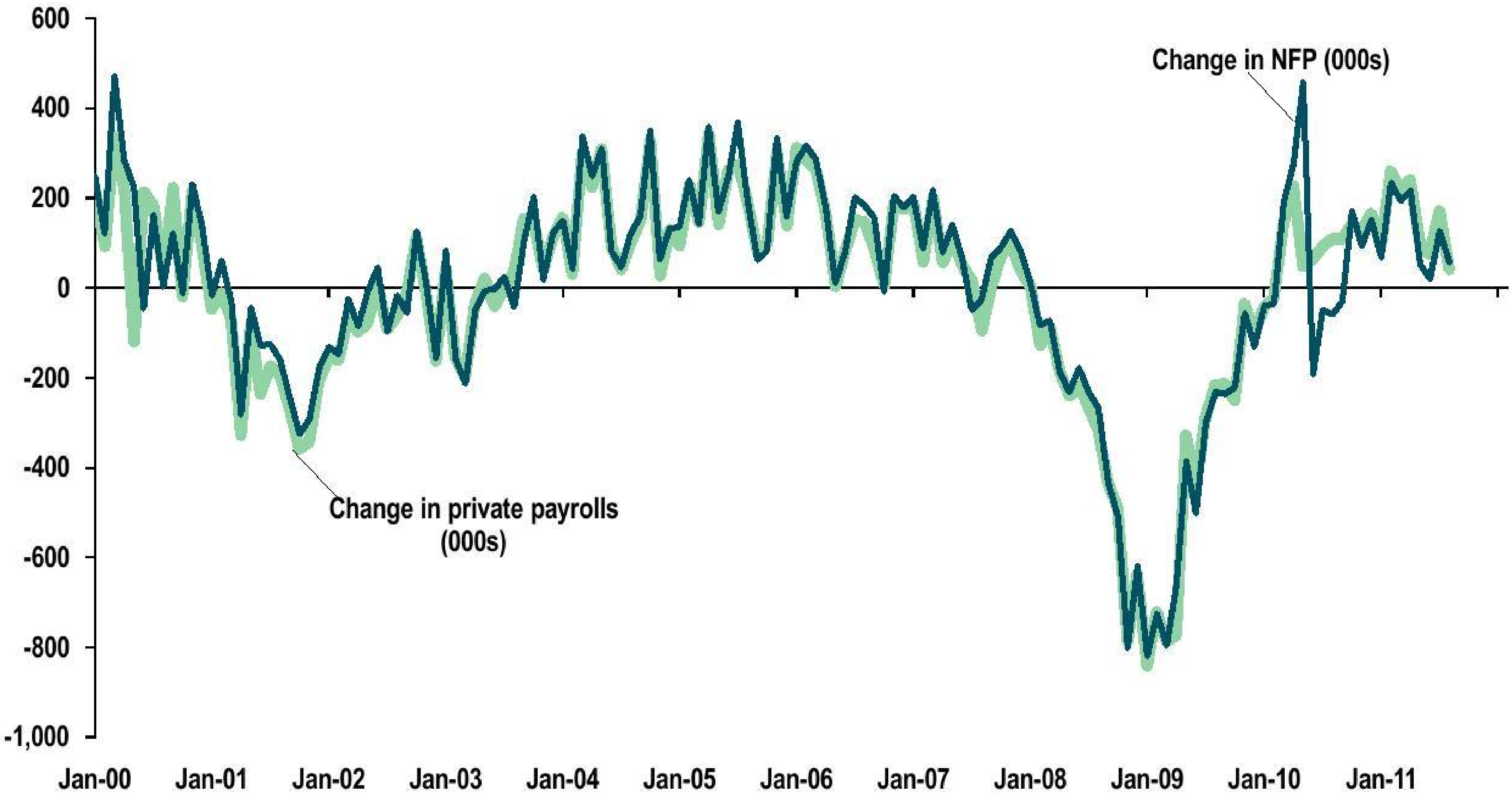
Sources: Bloomberg, Standard Chartered Research

US large firms are still doing OK



Sources: Bloomberg, Standard Chartered Research

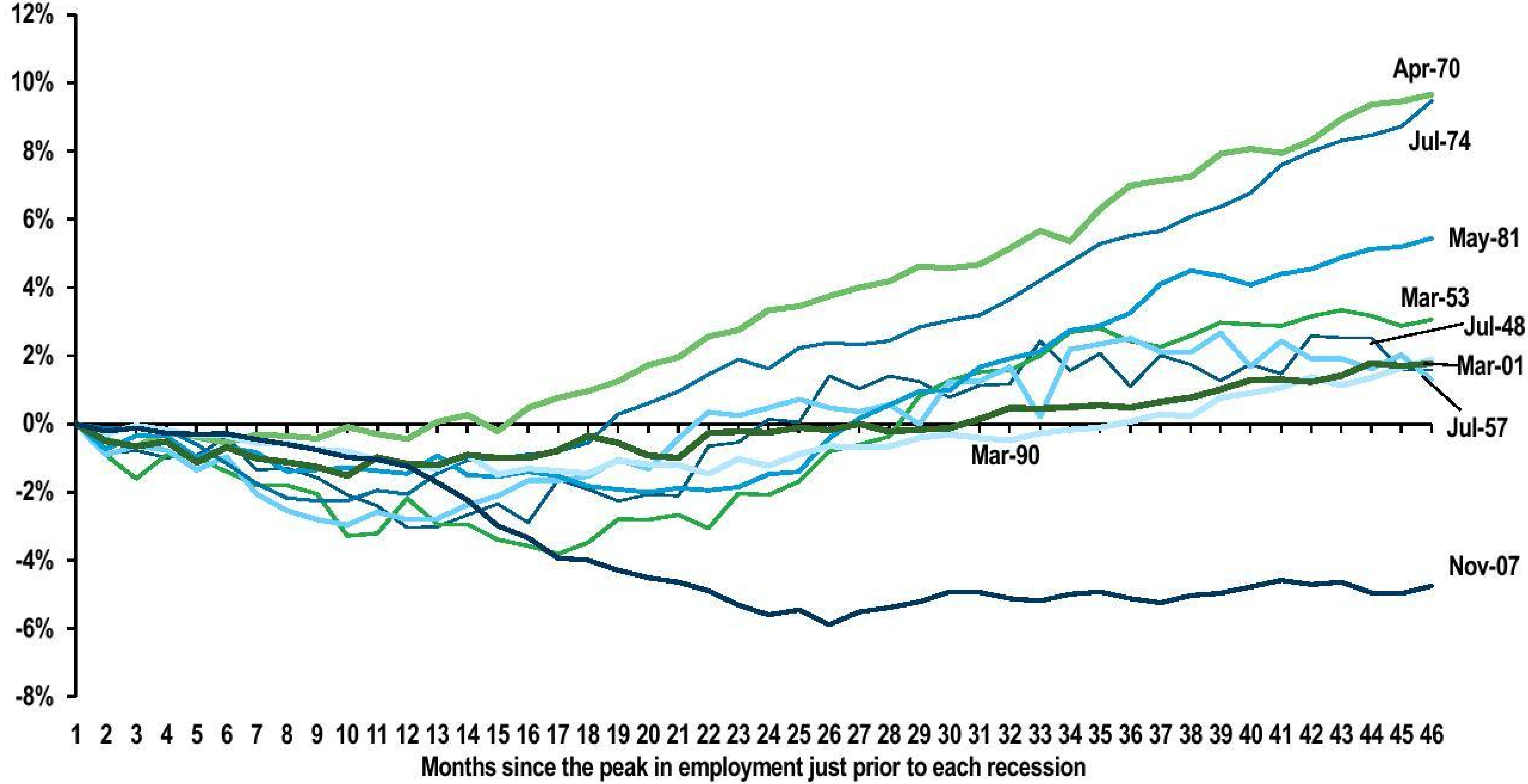
US is not in recession (yet, at least) – Non-farm payrolls



Sources: Bloomberg, Standard Chartered Research

Employment change since peak, by recession

The most recent experience is by far the worst for job losses in post WWII history



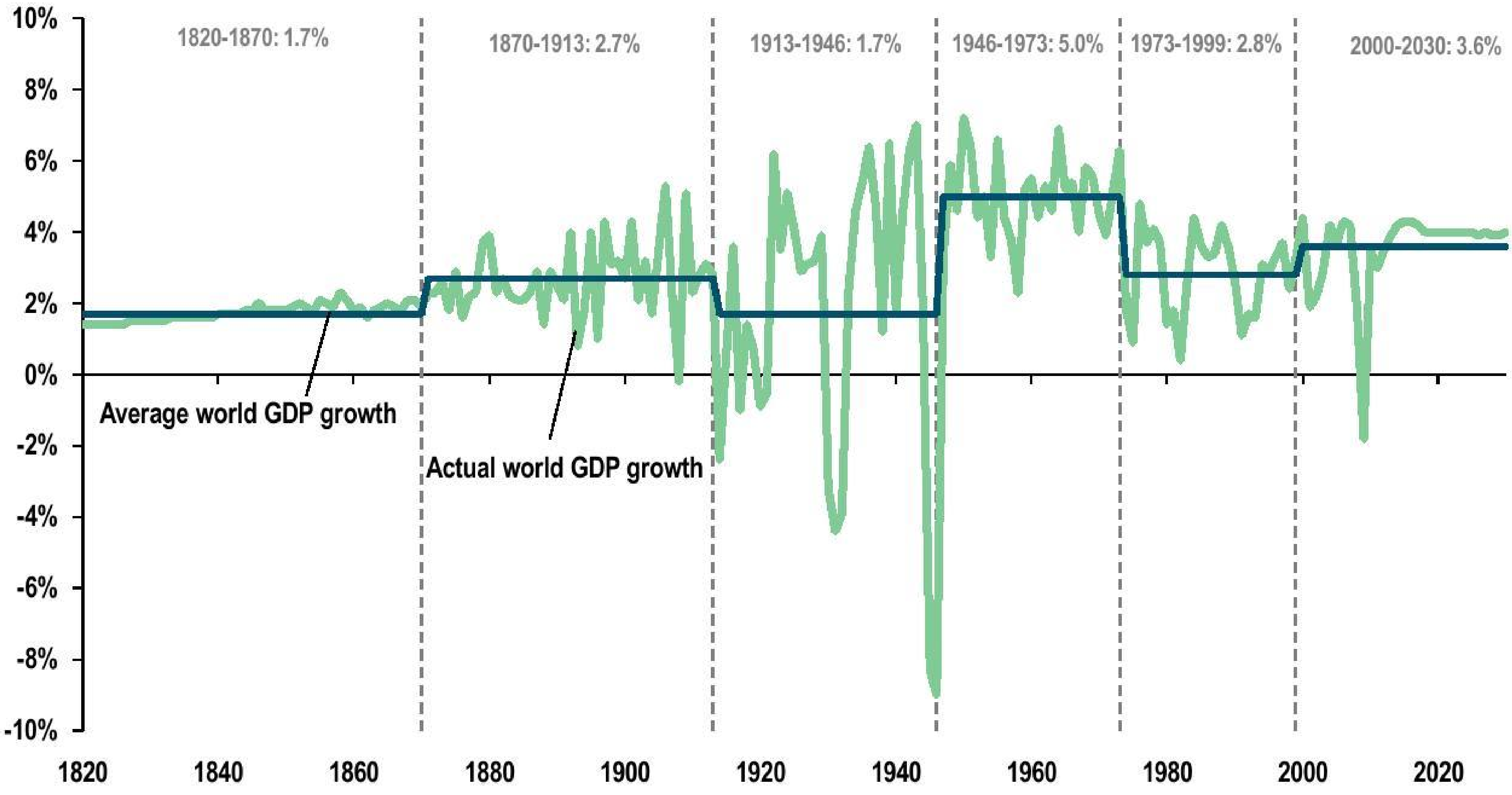
Political deadlock

- Europe
  - Largely about who will pay for the fiscal excesses in Greece and the credit busts in Spain and Ireland
  - Continuing reform is a key concern
- US
  - Republicans resist all tax increases
  - Democrats still have strong spending agenda (e.g., healthcare)
  - Tea Party and “Occupy Wall Street” reflect distrust of politicians, but complicate policy
  - US presidential election is still wide open
- Japan
  - So hard to deliver reform
  - Bank of Japan scared to pursue QE as vigorously as it should

E for expansion, empowerment, excitement and exuberance

Three Super-cycles

Real world GDP growth since 1820 *(%)*



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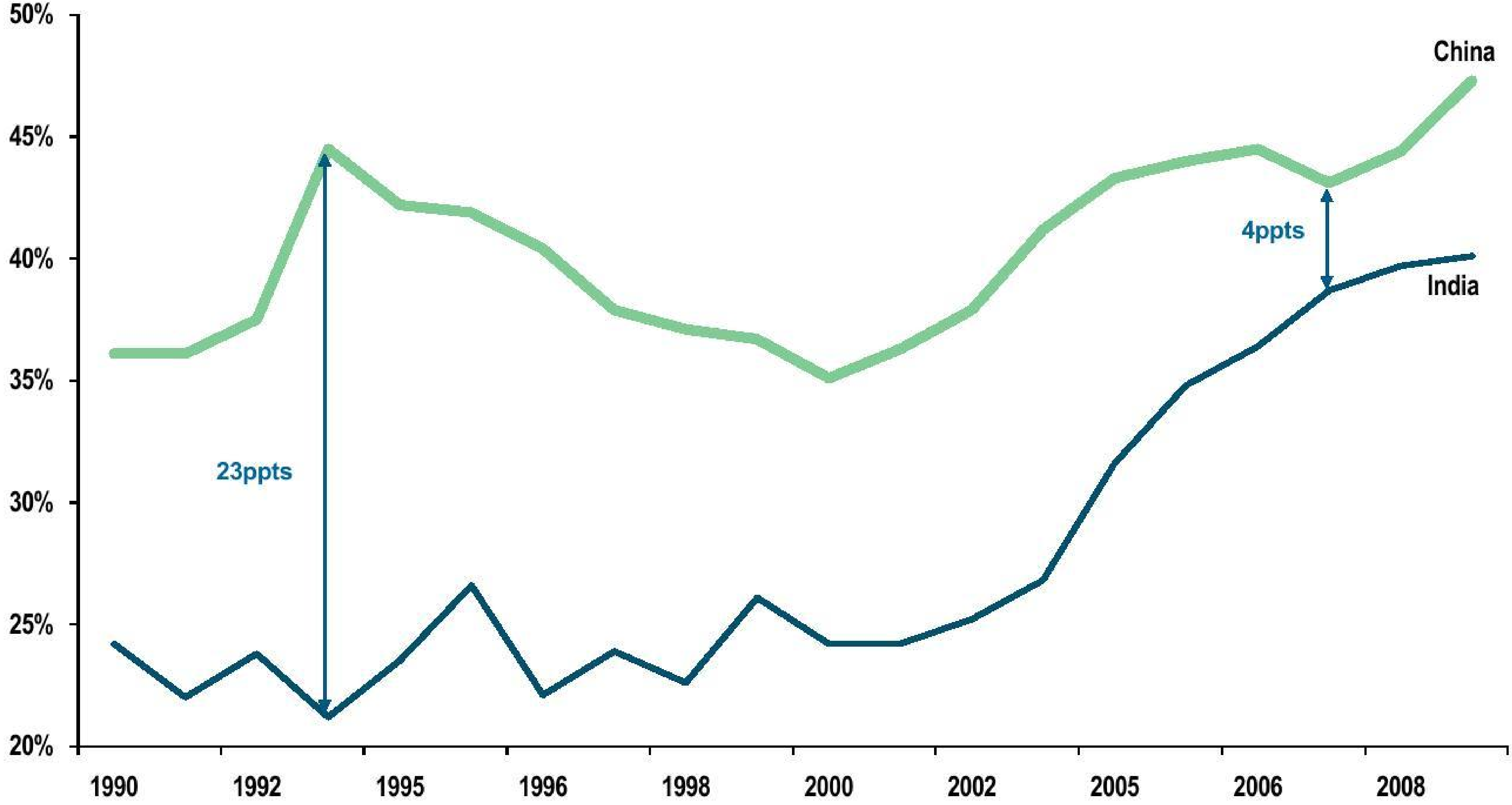
Sources: Maddison, IMF, Standard Chartered Research

Drivers of super-cycles

- Fast growth as new countries open up and gain scale
  - 1870-1913 – US
  - 1946-73 – Japan, (plus European recovery)
  - 2000-30 – China, India, Indonesia, Africa
- Network technologies
  - 1870-1913 – Railways, telegraph,
  - 1946-73 – Roads, telephones
  - 2000-30 – Internet, cell-phones
- Peace
- Stable monetary environment
- Trade opening

China and India both investing for rapid growth



Sources: IMF, Standard Chartered Research

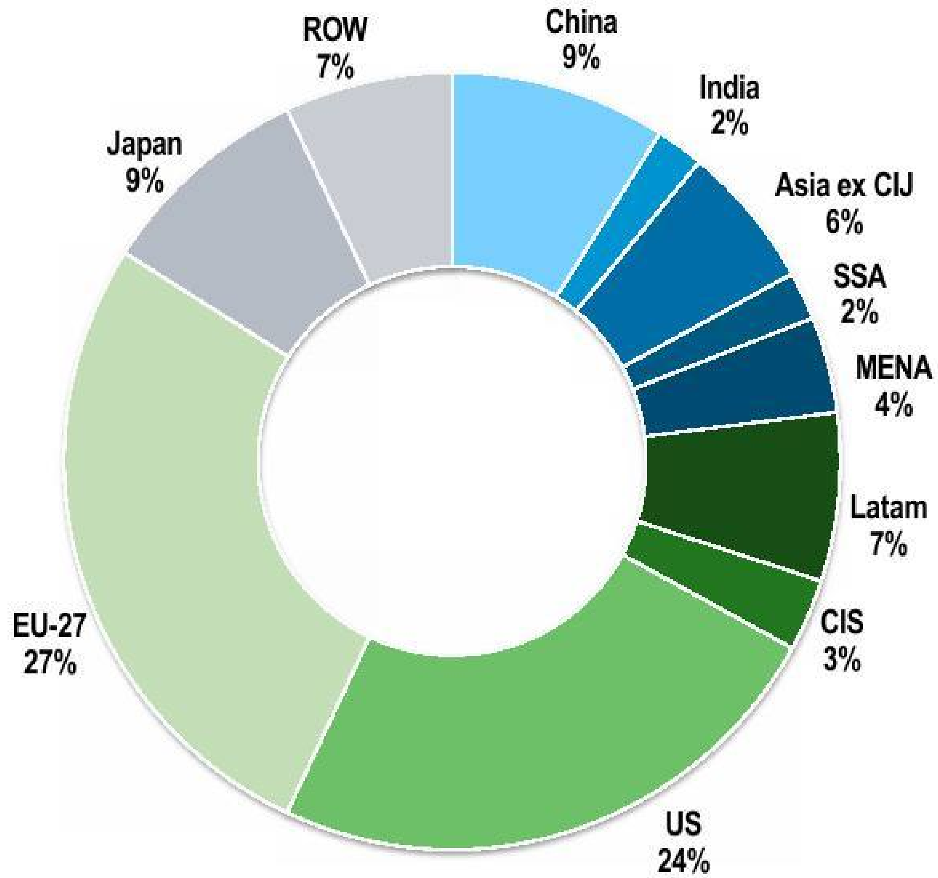
What changed in about 2000 to start the current super-cycle?

- Scale – China is 10% of world economy now, large enough to affect global figures
- Tough times for emerging countries ended
  - Two decades of Latam inflation and debt crises ended with Argentina 2001
  - Asia crisis over
  - Ex- Soviet bloc turning up after post-Communist slump
  - Africa began to show more widespread reforms and helped by commodities
- Commodity cycle began to turn up – new investments in infrastructure
- Trade opening – Uruguay Round 1994; China joined WTO 2001
- Internet and trade opening gave huge boost to "globalisation"
- Acceleration in US productivity growth

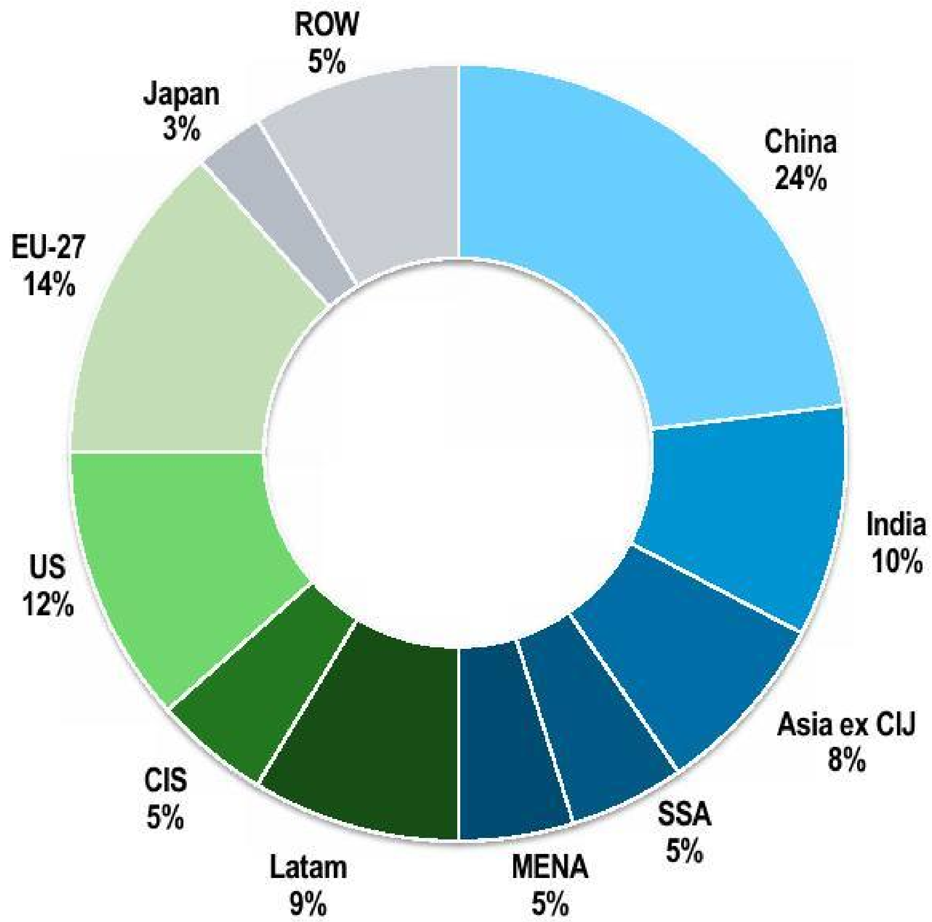
NB. We are not forecasting that 2030 will be the end. Only for data comparison

The shift in the balance of power towards emerging countries

Nominal GDP 2010, USD 62trn
% of global



Nominal GDP 2030, USD 308trn
% of global



Sources: IMF, Standard Chartered Research

The New World Order

	1990	USD trn	2000	USD trn	2010	USD trn	2020	USD trn	2030	USD trn
1	US	5.8	US	10.0	US	14.6	China	24.6	China	73.5
2	Japan	3.0	Japan	4.7	China	5.9	US	23.3	US	38.2
3	Germany	1.5	Germany	1.9	Japan	5.6	India	9.6	India	30.3
4	France	1.2	UK	1.5	Germany	3.3	Japan	6.0	Brazil	12.2
5	Italy	1.1	France	1.3	France	2.6	Brazil	5.1	Indonesia	9.3
6	UK	1.0	China	1.2	UK	2.3	Germany	5.0	Japan	8.4
7	Canada	0.6	Italy	1.1	Italy	2.0	France	3.9	Germany	8.2
8	Spain	0.5	Canada	0.7	Brazil	2.0	Russia	3.5	Mexico	6.6
9	Brazil	0.5	Brazil	0.6	Canada	1.6	UK	3.4	France	6.4
10	China	0.4	Mexico	0.6	Russia	1.5	Indonesia	3.2	UK	5.6

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Source: Standard Chartered Research

Empowerment means lots of different things

- Global politics
  - G20 is now the key global talking shop for economics
  - Rise of China and other Asian countries is redefining international relations
  - "Failure" of US "free market" model is encouraging other views – not always good
- Growth + internet/cell phone connectivity is transforming business and politics
  - SMEs more easily able to trade
  - Information flows more readily
  - "Arab Spring" is partly a result
- The numbers of highly educated people are exploding around the world
  - A challenge and an opportunity

Implications for commodity prices bullish but . . .

- Huge demand as emerging countries catch up, urbanise
- Low prices in 1990s constrained search and development for new sources
- High prices needed to get the investment required
- But many prices now well above marginal cost. In time, increasing supply could bring downward pressure
- Commodity upswings usually last 20 years or so
- 8-10 years in, implying further to go
- But not a permanent change
- Nor a one-way bet – always volatility as we see now

Risks to the Super-cycle – (1) Euro crisis leads to world recession

- If the recession is mild the Super-cycle story is still intact
- If it is severe, that is harder to argue, begins to seem like a depression
- The private sector is better prepared for recession now
  - Stronger balance sheets
  - Higher savings rate
- But governments have less room for stimulus
- And the politics could get ugly

Risks to the Super-cycle – (2) US another Japan?

- Arithmetic effect – US is one-fourth of world economy
- Slow locomotive effect? But:
  - US cannot be the locomotive any more, since imbalances have to close
  - Slower US growth means lower world interest rates and lower commodity prices, which could help other countries
- Bottom line – we will not call it a Super-cycle in retrospect if the US is another Japan; but the shift in relative power to the East could go even faster.

Risks – (3) Hard landing in China

- China's economy "unstable, unbalanced, unco-ordinated and ultimately unsustainable" - Premier Wen Jiabao
- Very high investment-to-GDP ratio at about 46%
  - Building tomorrow's infrastructure and improving the housing stock?
  - Or inevitably threatening over-capacity and declining returns?
- Risk is that some kind of crisis/recession leaves massive overcapacity
  - But strong fiscal and FX position, so China could spend its way out again
  - Policy is to boost consumption and slow investment over time.
  - Right now, China is on course for a soft landing

Conclusion: We are worried, but optimistic!

The Super-cycle will return soon!

- The euro area has the capacity to solve its problems
  - Total euro-area debt ratios are better than in Japan, US and UK
  - Significant reforms are in progress – pensions, labour markets, product markets
  - Leaders in Europe are still strongly committed to integration
- Both the US and Europe are still growing – no recession yet
  - Confidence is low but there is less shock and panic now than in 2008
  - Private-sector deleveraging and bank capital re-building has made significant progress
- The emerging-market story is still intact
  - Savings and investment are high
  - Reforms are progressing – albeit at variable speeds

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