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CAPITAL MANAGEMENT

Strategy & Economics - Richard Jeffrey

A View from Moorgate

Issue No. 3 10th April 2012

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Changing tunes

Once upon a time, not so long ago, the world economy was dominated by the United States. It played Pied Piper to most other countries, leading the way both into downturns and upturns. With the emergence of China as an industrial force, however, there are two economies now competing to call the tune, and this has introduced an interesting and potentially disruptive dynamic within the international economic cycle. When analysing the impact of this new dynamic, there is a further complication to take into account: whereas the US economy is a generator of demand, China's role is more on the supply side (unless you happen to be a manufacturer of Western luxury goods or a supplier of commodities).

At the start of this year, economists were relatively gloomy about the outlook for Western growth, but appreciably more positive about prospects for Asia. Moving the story on, there have been subtle changes within expectations. By and large, there have been positive shifts in sentiment with regard to some of the more important Western economies, but concern is growing over the outlook for economies in the East. Most significantly, perhaps, numbers emanating from the US have suggested that the economy is gaining momentum quicker than had been predicted. One of the more encouraging features of this improvement has been the evidence that the small and mid-cap area of the economy is leading the way, suggesting that the recovery is establishing a broader base.

Typically, European economies have tended to follow the US lead, but with a time delay of around six months. Clearly, the picture is currently more complex. While Germany is generating more momentum that had been widely forecast, southern European economies remain mired in the debt/euro crisis. Lending via the LTRO may have reduced the risk of defaults in this area, but the additional liquidity within the euro-area banking system seems to be having more impact on German asset prices, and in time this is likely to be reflected in more positive trends in domestic demand.

Output and demand trends in the UK have also proven more robust since the turn of the year than most economists were anticipating. As I have suggested previously, I think that growth here will top 1% in 2012, compared to consensus forecasts of less than 0.5%. While this may not be enough to prevent unemployment from continuing to rise, it will allow further rebalancing to take place, with the trade deficit falling further and the faster expansion in private sector activity compensating for the necessary squeeze on the public sector.

Over in Asia, trends have taken a turn for the worse. In particular, the evidence is that China is facing growing challenges in terms of its domestic economy. While inflation has not fallen as fast as expected, growth in retail sales and industrial production have dropped sharply. While for specific Western exporters, duller activity trends in China may pose a threat, the more positive angle is that slower Chinese growth should reduce upwards pressure on commodity prices. So, what is not so good for the East may be helpful to the West.

While it cannot be doubted that, in world terms, China is becoming an ever more important locus of growth, it may prove that for 2012 it is the US that is more important in setting the pace. On my analysis, this will be of specific benefit to the UK.

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