

Schroders

Economic and Strategy Viewpoint

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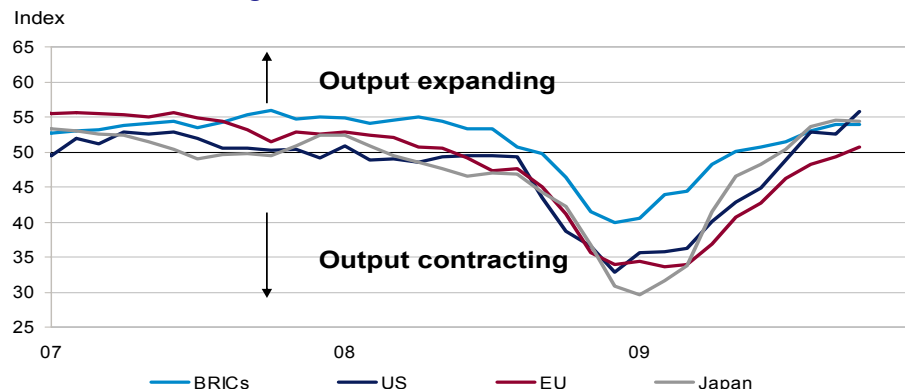
Forecast update: stronger recovery but no early tightening

- We have revised up our forecasts for global growth and now expect the world economy to expand by 2.7% in 2010, around 0.5% higher than previously forecast. The inflation forecast is little changed for the OECD countries, but has been raised for the emerging markets where we see a risk of overheating. On interest rates, we see a later tightening of policy in the US, Eurozone and UK, in line with comments from the G20 and central banks who see no rush to start the exit strategy from loose policy.
- In terms of growth profile, we continue to forecast a “W” with a slowdown in growth in mid-2010 as the boost from the inventory cycle fades and the headwind from the credit crunch continues. Fiscal policy should continue to support growth in the US and China in 2010 although the fiscal boost will fade in the UK as indirect taxes rise.
- We have also revised up our US profits forecasts which benefit from the improvement in productivity, helping to drive the profit share higher. Stronger profits ultimately provide the base for a sustainable recovery as they lead employment growth so helping consumer incomes and confidence. As a result, we would see the last up leg of the W in 2011.

Europe: Sluggish growth

- As the US and Eurozone exit recession, we have updated our forecast and upgraded growth across Europe. Recent European GDP data disappointed consensus estimates, but beat our own forecast, and so with the upgrade to our US and emerging markets growth forecasts, we have also raised our 2010 GDP forecast for the Eurozone to 1.2%, and to 1.1% for the UK.
- However, rising unemployment across Europe, low productivity and impending fiscal tightening will weigh down on growth in 2010 and 2011. We expect the UK to outperform Eurozone growth in 2011 thanks to a more flexible labour market and more aggressive job shedding over 2009.
- Despite the upgrade to growth, we continue to forecast subdued inflation across Europe, typified by weak and falling core inflation due to huge spare capacity that has emerged because of the recession. Taking our growth profile with political pressure to keep monetary policy loose to accommodate fiscal tightening in 2011, we have pushed back our forecasted interest rate hikes for the end of 2010.

Chart: Manufacturing PMIs –BRICs vs. OECD



Source: Markit, 19 November 2009. The PMI for the BRICs are GDP weighted in nominal USD terms: Brazil (18%), Russia (19%), India (13%) and China (50%).



Global

Forecast update: Stronger recovery, but no early tightening

Recent economic figures show a return to global growth during the third quarter of the year. Although this was always part of our baseline forecast, increases in GDP have been ahead of our expectations indicating that we need to revise up our growth projections. In particular, the inventory cycle is likely to make a larger contribution than previously expected and will boost output in the fourth quarter of this year and the first quarter of 2010.

The industrial sector has been the main beneficiary of this and business surveys suggest that production will continue to recover into 2010. From a regional perspective, the recovery was led by the emerging markets with Japan and the US coming next and Europe lagging behind (chart front page).

We still see the shape of the recovery as a “W” where growth falls back in 2010 as the boost from the inventory cycle, lower energy prices and this year’s tax cuts fades away. However, the “W” now has more of an upward tilt and we have more conviction than before that a double-dip (i.e. a return to recession) will be avoided.

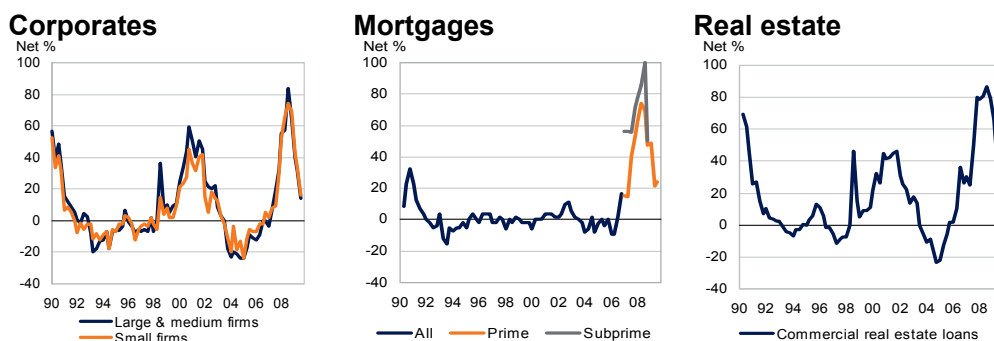
Global growth returns, led by the emerging markets

Still looking for a “W”

Credit crunch to continue into 2010

The credit crunch is expected to roll on into 2010 as banks continue to restrict lending and borrowers remain wary of taking on more debt. There has been an improvement in this area. For example, surveys suggest that the number of banks tightening financial conditions has fallen (chart 2) and with the re-opening of equity and credit markets many firms have been able to by pass the banking sector by going directly to investors for funding.

Chart 2: Loosening the tourniquet: net % banks tightening lending



Source: Thomson Datastream, 18 November 2009

Credit crunch hitting small companies most,

This is encouraging, however overall lending conditions are not easing – they are just less tight. Within the economy there also seems to be a divergence between small and large companies. The former are reporting more difficult conditions in obtaining finance, perhaps a reflection of their dependence on bank credit and an inability to go directly to the markets. From a market perspective, this suggests that the recent out performance of small over large companies may have run its course.

...although large property firms remain vulnerable

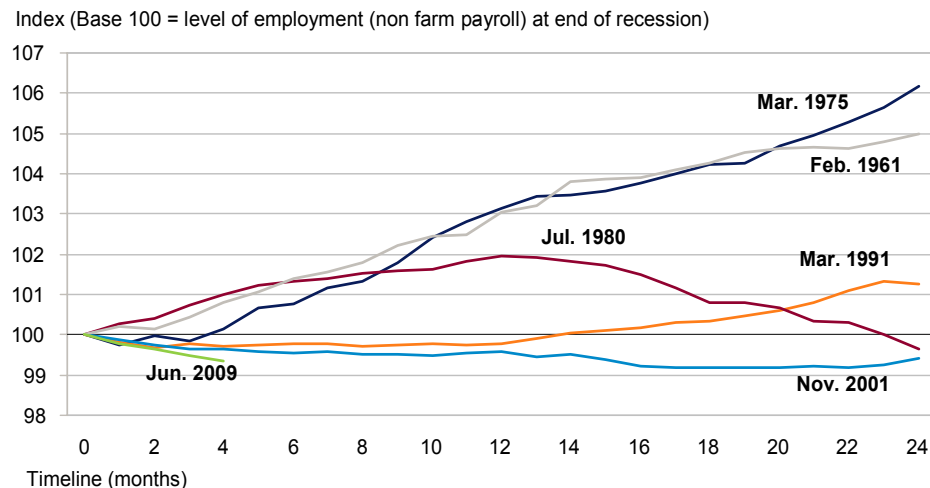
Some large companies still face problems. For example, in commercial real estate in the US, the market for Commercial Mortgage Backed securities (CMBS) has yet to re-open. With \$500 billion of annual lending to refinance over the next few years this presents a potential hazard to the sector unless banks take a flexible approach to enforcing loan covenants, or an alternative source of finance emerges. In practice, we will probably see the Federal Reserve extending its lending facilities through the Term Asset-Backed Securities Loan Facility (TALF) beyond March (for existing CMBS borrowers) and June 2010 (for new loans).

Looking for a turn in the labour market

Where we are becoming more optimistic than consensus is on the US labour market. Unemployment jumped sharply in October taking the rate to 10.2%, the highest reading since March 1983 and the source of much gloom. The weakness of the labour market was highlighted by Federal Reserve chairman Bernanke in a recent speech where he saw the lack of job growth as a major headwind on recovery.

Jobless recoveries are not unusual. The past two recoveries saw employment lag the upturn in output. For example, in the upturns which began in 1991 and 2001 employment continued to fall for more than a year as output recovered (chart 3). The labour market is a lagging indicator as companies will first be able to meet increased demand by working their existing workforce harder. Only when constraints on production begin to emerge do they start to recruit.

Chart 3: Another jobless recovery?

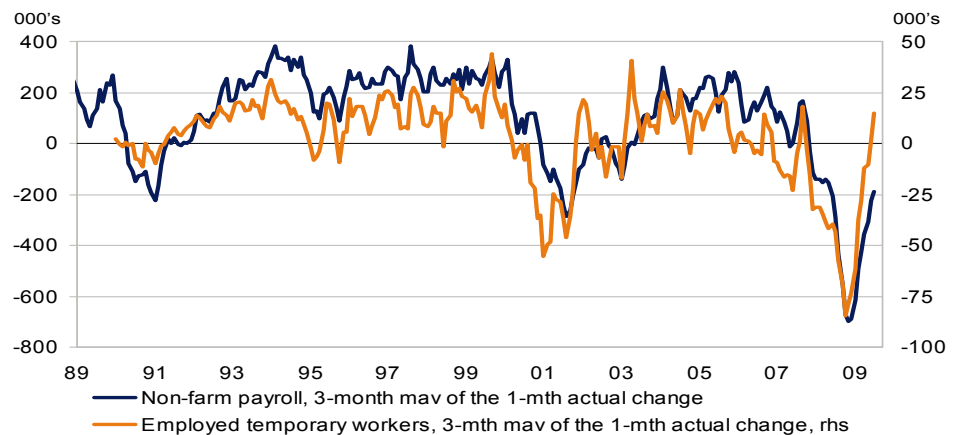


Source: NBER (National Bureau of Economic Research), Thomson Datastream, Schroders
 Note: End of recession phases based on NBER's definitions except for this recession (assume that the US exits recession during June 09). Dates in the chart refer to end of the recession/start of the recovery.

The coming recovery is unlikely to be different and the lag could be quite long given the size of the output gap. Nonetheless, we would point to two indicators which suggest we will see an improvement in the labour market in coming months.

Increase in temporary workers...

In the near term, there has been a noticeable increase in the number of temporary workers. Companies often respond initially to better conditions by increasing this section of the payroll as it can be easily reversed should higher demand prove to be short lived. Although there could be such a reversal, the increase registered so far in temporary help suggests that the widely followed non-farm payroll figure could turn positive as early as the first quarter of next year (chart 4 on next page).

Chart 4: Rise in temporary workers signals turn in payroll

Source: Thomson Datastream, 18 November 2009

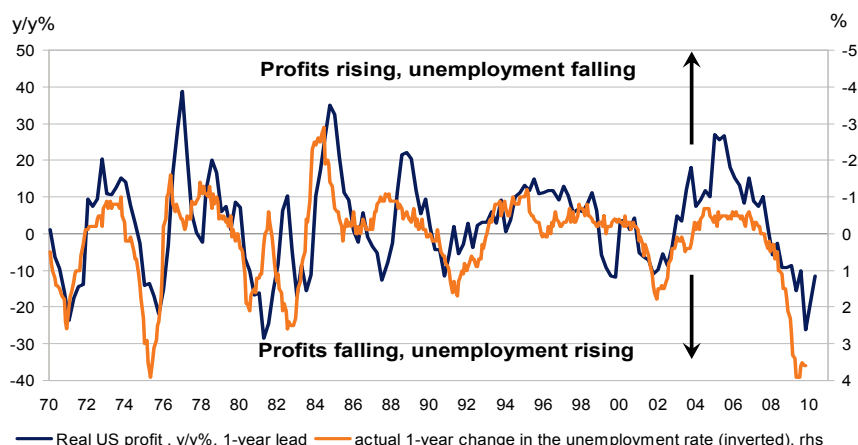
...and strong productivity indicate a return to job growth

Second, the recent productivity figures in the US have been very impressive. Figures for the third quarter showed a gain of 31% (annualised) one of the strongest on record. As noted above, spare capacity means that healthy productivity gains are not unusual for the stage of the cycle. However, they have been particularly strong this time around.

The best explanation, in our view, is that companies over reacted on the cost cutting front during the second half of last year and first quarter of this year as at the time they were fearful of another Great Depression. Now that we have seen a turn in activity, companies find that they are going into the recovery with a very lean workforce and consequently are in a strong position to achieve productivity gains. It is possible that some of these gains will prove to be permanent, but more likely than not they suggest that future output gains will translate more rapidly into employment.

In the meantime, strong productivity is feeding into a rapid recovery in profits. The third quarter earnings season in the US has so far seen 83% of companies beat expectations, even though only 57% beat sales expectations. Such a combination is only possible when the profit share in national income is rising, enabling earnings to outpace GDP growth. We expect earnings growth to come in at 28% in 2010, comfortably outpacing the rise in GDP of 2.2% (see Table 2 below for more details).

Increases in earnings are helping to support the rise in equity markets. However, they also provide a basis for a sustainable recovery as profitable companies seek opportunities to expand output. There is an approximate lag of 12 months between rising profits and falling unemployment, pointing to a stronger labour market by the second half of 2010 (chart 5 on next page).

Chart 5: Swings in profits lead unemployment

Source: Thomson Datastream, Schroders, 19 November 2009

Credit crunch could threaten the expansion

If we are right then this should provide the basis for the final upward leg of the W as we move into 2011. Falling unemployment not only supports household income, but also reduces precautionary savings thus helping to boost consumption.

The biggest risk to this forecast is that the banking sector does not provide the funding for companies to expand. The supply of credit remains restricted, thus choking off the upturn. Improvements in bank profitability suggest that the sector is getting back to a position where it has repaired its balance sheet and can lend again. However, IMF analysis suggests these are still a considerable number of write-offs to come and could keep banks cautious.

Policy tightrope

From the policy perspective, we are faced with a delicate balancing act. The authorities have made it clear that they will require banks to hold a higher and more liquid level of capital going forward than before. There should be no re run of the tax payer bail out so banks need to be safer. However, the current requirement is for the banking sector to support the economy by lending more. We need banks to become risk takers again.

One way to square this circle is for monetary policy to remain loose for an extended period of time enabling banks to rebuild profitability and find opportunities to lend. Thereafter, the authorities can put in place the regulation needed to create the new, safer banking system.

On this basis interest rates are set to remain low until well into 2010. The view is reinforced by three additional factors.

Rates to remain low

First as described above, the recovery will not be a straight upward trajectory, more W than V, causing policy makers to pause. Furthermore, there are doubts as to how the economy will react to the ending of Quantitative Easing (QE), liquidity provision and the Fed's special lending programmes. QE is currently scheduled to end in March in both the US and UK. Second, monetary policy needs to accommodate a gradual, but significant tightening of fiscal policy. Third, we believe that after a commodity led pick up in headline inflation in coming months, price pressures will moderate and deflation will be seen as the greater risk.

Consequently, we are pushing our forecast for the first US rate rise out to September next year with a risk that it could be even later. We still expect the ECB and Bank of England will not increase rates until after the Fed and have pencilled

in rises for September and October 2010 for the UK and Eurozone. Thereafter we see rates rising, albeit slowly and are likely to peak at a lower level than seen in previous cycles.

Output gap to weigh on prices in developed economies

But emerging markets face greater inflation risks

More on Inflation

After falling sharply in 2009, headline inflation is forecast to rise in 2010 following the recovery in commodity prices. However, outside commodities, deflationary pressures persist and the US is expected to experience a decline in core inflation (CPI ex. food and energy) through 2010. In the absence of further gains in commodity prices, the slack created by the downturn keeps downward pressure on inflation such that the headline rate falls back in 2011.

Strong liquidity growth in emerging markets

The benign inflation outlook for the OECD is not entirely shared by the emerging markets. To focus on China, at present the economy is experiencing deflation - a consequence of the year-on-year fall in commodity prices which is driving down annual inflation rates around the world. However, going forward, the outlook is less favourable as there is less spare capacity than in the developed economies (chart 6a). Consequently, the output gap is likely to disappear more rapidly, heralding the return of inflation.

In economies like China there is the additional problem of excess money growth following the surge in credit earlier this year. Although the relationship with inflation is not always perfect, as excess money can go into other areas such as equity or property prices, the acceleration in M1 does suggest significantly higher consumer price inflation in 2010.

Chart 6a: Capacity utilisation in the US and China

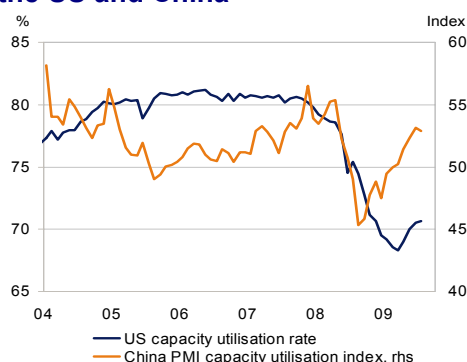
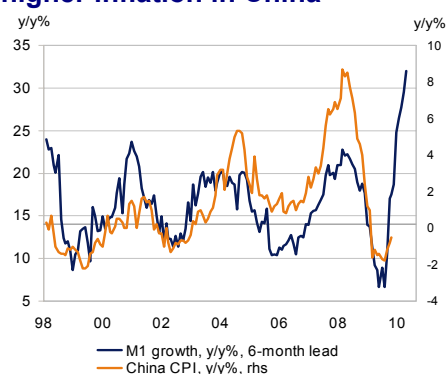


Chart 6b: M1 growth indicates higher inflation in China



Source: Thomson Datastream, Markit, Schroders, 23 November 2009

This cyclical divergence between the developed and emerging economies adds to the case for an appreciation of the emerging currencies, particularly a revaluation of the Chinese Yuan. The case based on fundamental factors was discussed in the last Viewpoint¹.

¹ See "The dollar, re-balancing and the world economy", Economic and Strategy Viewpoint, 30th October 2009

Forecast changes

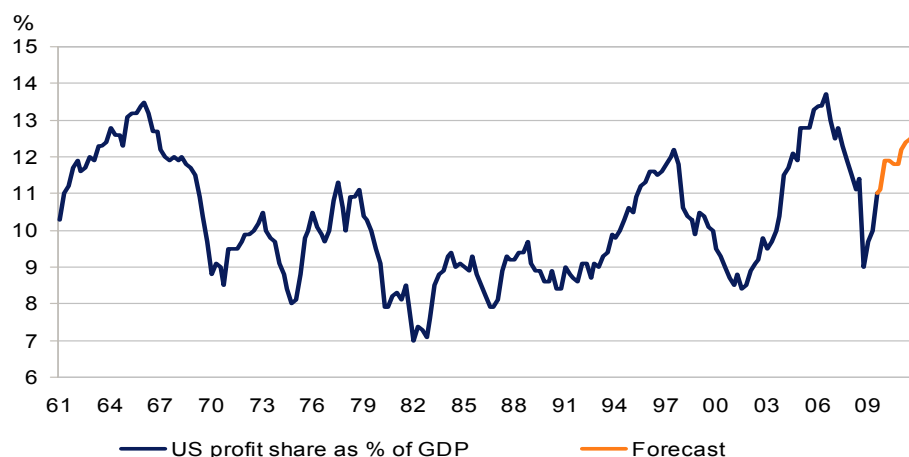
We have upgraded our forecasts for global growth in 2010 to 2.7%, an increase of 0.5% on our previous forecast. The forecast for both the OECD and the emerging markets have been revised up. Inflation is forecast to be slightly higher although the increase is almost entirely concentrated in the emerging markets where we see a risk of overheating. On the interest rate front we have pushed out the first rate hike from the US Fed and Bank of England to September (previously June) with the ECB going in October.

Table 1: Forecast comparison

	Previous	New	Difference	Previous	New	Difference
Real GDP	2009	2009	2009	2010	2010	2010
OECD	-3.5	-3.5	0.0	1.3	1.7	0.4
Emerging*	1.5	1.1	-0.4	4.5	5.1	0.6
World	-2.1	-2.1	0.0	2.2	2.7	0.5
Inflation CPI						
OECD	0.4	0.2	-0.2	1.4	1.5	0.1
Emerging*	3.0	3.3	0.3	4.0	5.4	1.4
World	1.2	1.1	-0.1	2.1	2.7	0.6
Interest rates						
US	0.25	0.25	0.0	1.50	1.0	-0.5
UK	0.50	0.50	0.0	2.00	1.3	-0.8
Eurozone	1.00	1.00	0.0	2.00	1.5	-0.5
Japan	0.10	0.10	0.0	0.25	0.1	-0.2

Previous: last Quarterly forecast September 2009

Chart 7: US profit share and forecast



Source: Thomson Datastream, Schroders, 25 November 2009

This drives our view on S&P earnings per share which are now expected to rise 15% in 2009 and 38% in 2010. Reported earnings rise faster in 2009 as write-offs drop out of the comparison. Although there are limits as to how far companies can raise profits through cost cutting and productivity gains, we do not believe they have been reached yet. The financial sector is also expected to benefit from the continuation of a low cost of capital, reduced competition, an upward sloping yield curve and a revival in capital market activity through fund raising and M&A.

Table 2: US profit forecasts

US	2008	2009	2010
Economic profits			
y/y%	-23.8	-4.2	27.7
Non.fin. share % GDP	6.4	6.3	7.7
S&P 500 EPS			
Operating \$	50	57	78
y/y%	-40	15	38
Reported \$	15	51	70
y/y%	-78	241	38
S&P 500 PE market at: 1106			
<i>Based on operating EPS</i>	22.3	19.5	14.1
<i>Based on reported EPS</i>	74.3	21.8	15.8

23rd November 2009

Source: Thomson Datastream, Schroders, 25 November 2009

Europe

Sluggish growth

As US and Eurozone exit recession, we have updated our forecast and upgraded growth across Europe. We continue to question whether Europe as a whole will enjoy a strong recovery and advocate a 'W' shape profile, with an easing in activity in 2010. We forecast the recovery to gather pace at the end of 2010 and over 2011 as unemployment begins to fall, and consumers find their feet (and their wallets).

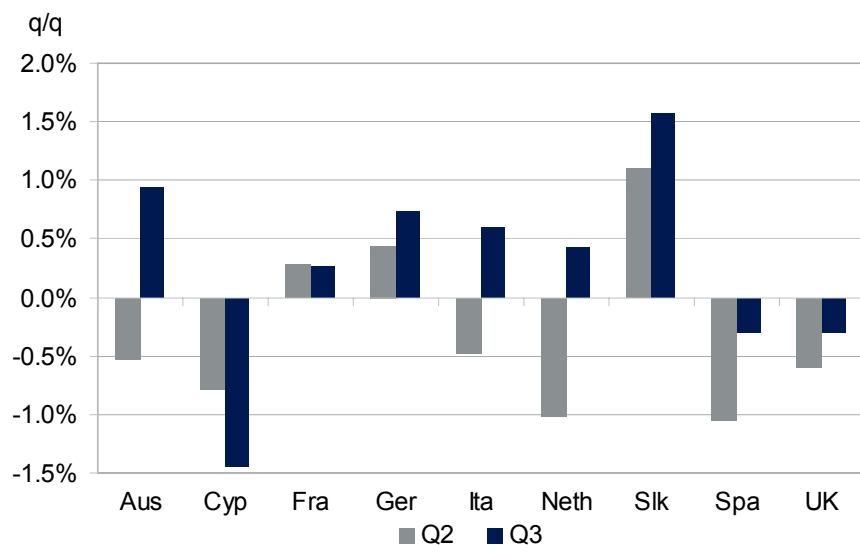
Recent data

Q3 GDP disappointed consensus but beat our forecast...

The latest data for third quarter GDP showed the Eurozone to have grown by 0.4% quarter on quarter, disappointing the Bloomberg consensus estimate of 0.5%, but beating our own estimate of 0.3%. Within the union, Germany expanded for the second consecutive quarter by 0.7%, while France grew by just 0.3%. Spain's structural problems continue to delay the start of its recovery, while Italy showed a strong pick up in growth, rising from -0.5% in the second quarter to 0.6% in the third. Other notable numbers included Austria and Netherlands exiting recession with 0.9% and 0.4% third quarter growth respectively.

The UK remained in recession in the third quarter despite strong signals from most private business surveys. However, the second estimate of third quarter GDP not only revised up the preliminary estimate to -0.3%, but showed that domestic demand in the UK has begun to stabilise. Moreover, there was no contribution from the inventories in Q3 which suggests that there could be a significant boost by the end of the year.

Chart 8: Latest GDP growth estimates



Source: DataStream, 26 November 2009

Growth prospects

...and so we have upgraded Eurozone & UK growth for 2010...

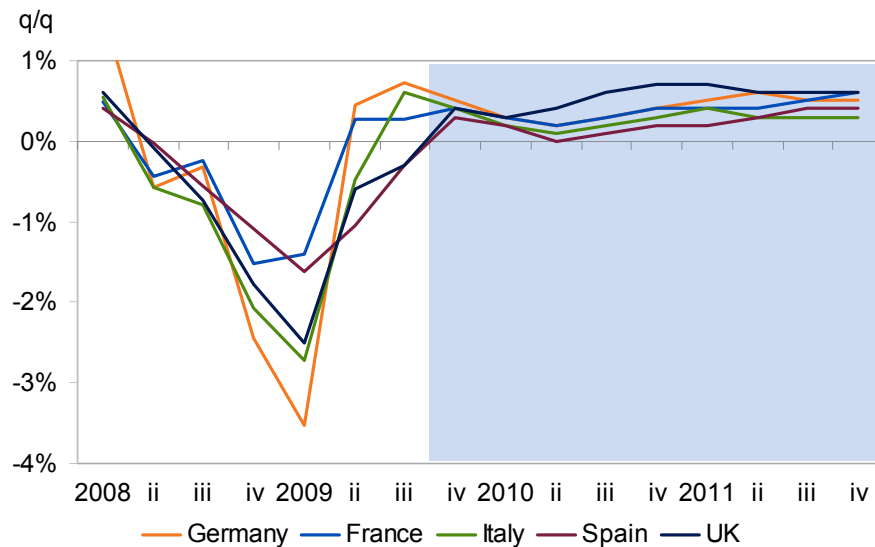
We have upgraded our Eurozone growth forecast for 2010 slightly from 1% to 1.2%, mainly due to an upgrade to our US forecast but also due to reassurances from political leaders that fiscal tightening is unlikely to begin until 2011. The 0.2 percentage point upgrade is small as we believe that the lack of job shedding across the Eurozone, which has led to substantial falls in productivity, is likely to hold back profitability and investment over 2010.

Moreover, as the US goes through the up-leg and down-leg of its inventory cycle, the Eurozone is likely to face a fluctuation in activity through its export channel (rather than its own inventory cycle²). We expect this to coincide with Eurozone unemployment peaking in the first half of 2010, causing the Eurozone to follow a similar quarterly profile to that of the US. – a moderation in activity which resembles the down-leg of a 'W', and a pick up in growth once unemployment starts to fall and export demand resumes, the up-leg of the 'W' (chart 9).

...though we expect growth to remain sluggish in 2011.

Further out, we expect fiscal tightening in 2011, the hangover of high unemployment and a strong Euro to keep growth sluggish. **Without widespread and significant structural reforms, it is difficult to see how the Eurozone can achieve growth over the next decade that surpasses that over the last.**

Chart 9: European GDP growth forecast



Source: DataStream, Schroders, 26 November 2009

Job shedding in the UK has been far more aggressive compared to the rest of the Eurozone, though unemployment remains well below where most forecasters expected it to be. This has been achieved through flexible working arrangements, with workers more willing to reduce hours and take pay cuts in exchange for keeping jobs. Due to the more aggressive job shedding, we feel that the peak in unemployment is closer for the UK than the Eurozone.

Labour market flexibility will help UK to outperform Eurozone GDP growth.

In addition to the difference in labour market conditions, the impact from monetary policy, including the depreciation in sterling, appears to have benefited the UK more. The cost of the majority of UK mortgages is linked to two-year swap rates, which have fallen along with interest rates. In contrast, European households tend to have more long-term fixed rate mortgages, and so the pass through of rate cuts has not been as effective.

The above has led us to have a stronger growth profile for the second half of 2010 for the UK compared the big Eurozone countries (Chart 9), but also forecast the UK to achieve robust growth of 2.5% in 2011.

² See Inventory Cycles 101 in the previous Economic and Strategy Viewpoint, 2 November 2009.

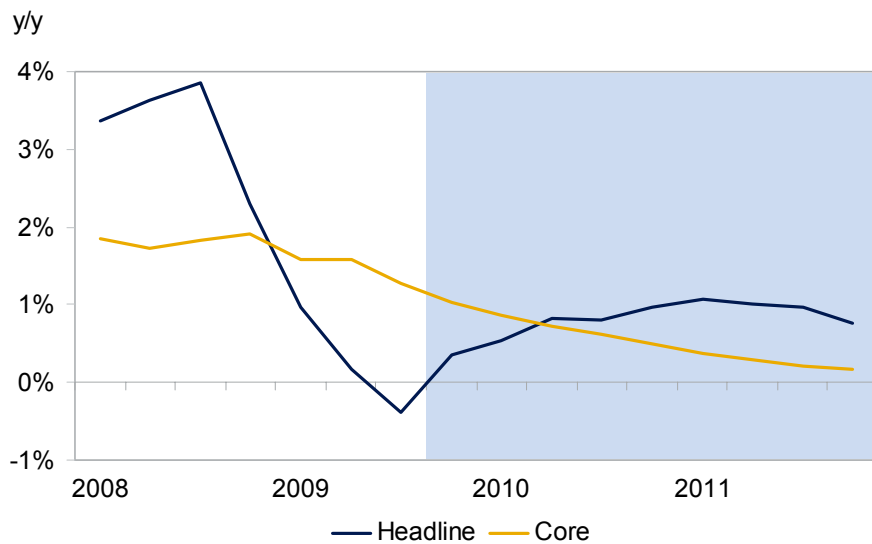
Inflation to remain subdued...

Inflation pressures?

Despite the upgrades to growth, inflation is set to remain subdued across Europe as a whole. On a year on year basis, inflation rates should begin to rise from their lows in recent months. Powerful base effects caused by high energy prices last year pushed inflation rates to very low levels, even negative levels in many European countries. As these effects fade, we expect headline rates to rise. More specifically, our baseline forecast includes increased inflation in emerging markets. Taken together with the unwinding of energy price base effects described above, Eurozone headline inflation is likely to rise in 2010, before price pressures ease in 2011.

However, when we exclude food and energy prices, the large amount of slack in economies should mean that deflationary pressures persist – pushing core inflation lower. We expect Eurozone core inflation to fall right the way through the forecast horizon (chart 10).

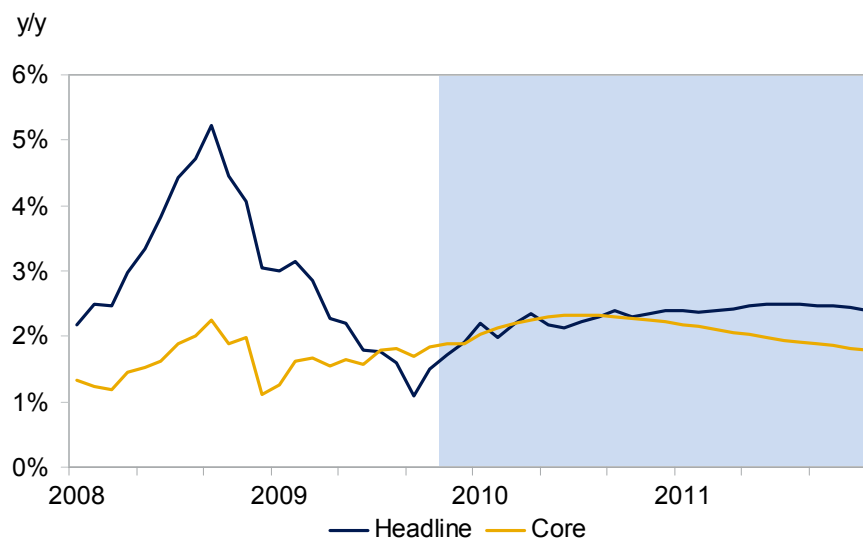
Chart 10: Eurozone inflation forecast



Source: DataStream, Schroders, 26 November 2009

...though reinstatement of 17.5% VAT will push up UK inflation.

The UK is an exception as can be seen in chart 11 (next page). Even though the UK also has ample spare capacity, we expect core inflation to pick up from January as VAT is reinstated at 17.5%. However, this should be temporary and we expect core inflation to peak by spring, and then continue to fall throughout 2011. Headline inflation in the UK should be supported by core inflation over 2010, but is likely to continue to rise in 2011 as growth accelerates.

Chart 11: UK inflation forecast

Source: DataStream, Schroders, 26 November 2009

Fiscal consolidation

Large fiscal consolidation looms...

Fiscal consolidation is inevitable. We can estimate roughly how much consolidation needs to take place for most economies, but the pace of retrenchment is dependent on two key factors.

The first is political will, which in itself is highly dependent on public appetite for fiscal tightening. While unemployment continues to rise in Europe, leaders will find it incredibly difficult to find public support for tax rises. Moreover, the European Union has a number of states (France and the UK to just name a couple) that have frequently failed to bring deficits down in the past (often wilfully), and as a result, faced the proverbial slap on the wrist from the European Commission in the form of the Excessive Deficit Procedure. The multilateral surveillance process is too lenient in allowing member states to put forward medium-term (5-year) budgetary programmes, but does not demand details of how fiscal targets will be hit in the interim period. This has in the past led to member states putting off the pain citing that they have 5-years to hit their medium term objectives. Hungary did this for some time before former Prime Minister Ferenc Gyurcsány admitted his party "...lied morning noon and night" to the Hungarian public about the dire state of government finances.

The second factor is the appetite of the bond market. At the time of writing, markets are reacting to Dubai World's (a flagship holding company of the Dubai state) request for a break on the repayment of its £48 billion of gross debt – sparking fears of the first major sovereign default since Iceland. While this event may prove to be nothing more than a storm in a tea-cup, the negative reaction of the market (Dubai SUKUK 5-year bond yield up approximately 235 basis points between 25th & close of 27th November) will remind authorities not to upset investors, particularly when supply of government debt across the world is so plentiful.

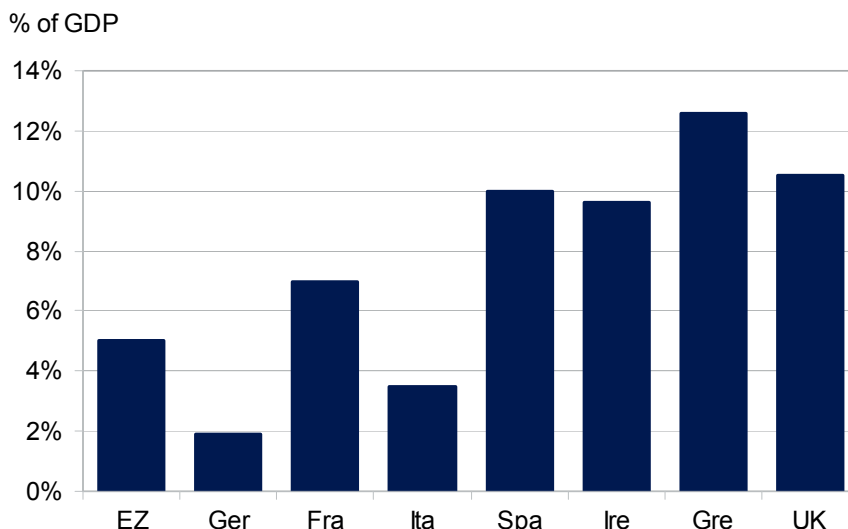
According to the European Commission's Autumn forecast, the cyclically adjusted government deficit in the Eurozone should reach 5% of GDP in 2009. This excludes the cyclical component of the deficit (estimated to be a further 1.9% of GDP) which would disappear assuming GDP growth returns to trend. Therefore, in order to stop government debt rising further over the medium-term, the cyclically adjusted balance must be reduced to zero.

...with the UK looking particularly vulnerable

That is, the Eurozone as a whole must tighten fiscal policy by 5% of GDP excluding the gains from the cyclical recovery.

However, in order to reduce the level of debt however, greater tightening is required. Chart 12 shows the estimated size of cyclically adjusted government deficits for 2009. Immediately, the UK stands out as a country that will need urgent tightening over the coming years.

Chart 12: Cyclically adjusted government deficits (2009)



Source: European Commission's Autumn 2009 forecast, 26 November 2009

No fiscal tightening until 2011.

At this stage, we are factoring in no fiscal consolidation in 2010, with some countries such as Germany and France continuing with fiscal stimulus. We do however have fiscal consolidation soon after, with the Eurozone as a whole reducing the cyclically adjusted deficit by 0.5% of GDP in 2011, and more aggressively thereafter.

For the UK, we have factored in approximately 1.5% fiscal consolidation in 2011, again, with that rising further out. Most of this will come through spending cuts and tax rises, possibly in the form of higher income tax. However at this stage, we have not factored in any additional increases in VAT, though the possibility remains a significant risk. This is important as it would create a spike in our inflation forecast if it were to happen.

Central banks

Given our 'W' shape recovery profile, we feel that the Bank of England (BoE) and the European Central Bank (ECB) will now keep rates on hold until September and October respectively (previous forecast was for June and August).

Central banks likely to accommodate fiscal tightening.

While the shape of our forecast has not changed, and indeed, we have upgraded our growth forecast, evidence is mounting that central banks are content at keeping rates lower for longer in order to guarantee growth over the next two years, but also to remain accommodative to allow for fiscal consolidation.

The European Commission has stressed that the forthcoming round of Stability and Growth pacts must focus on fiscal consolidation over the medium term. Monsieur Trichet (President of the ECB) has stated that tightening and the removal of liquidity should begin with fiscal policy.

In addition to comments from the Eurozone, the BoE extended its asset purchase programme (also known as quantitative easing) this month by an additional £25 billion, taking total planned purchases to £200 billion - due to end in February 2010. In addition, David Cameron – leader of the main opposition party in the UK, has stated that should the Conservative Party win the next General election (must be held by June 2010), they intend to hold an emergency Budget within the first 50 days of government. The huge amount of uncertainty that potentially large fiscal upheaval introduces for the BoE forecast may encourage the Monetary Policy Committee to 'wait and see' – something the committee is becoming increasingly good at.

While we are pushing back our forecasted rate hike dates, its important to remember that there is still a significant probability that European central banks hike sooner. Certain members of the ECB including Axel Webber would favour more hawkish policy action to combat any inflationary pressures at the cost of higher growth. Raising the main refinance rate to 1.25% would restore the preferred 1% corridor with the deposit rate.

Forecast Summary

I. Forecast summary

Real GDP

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus	2011	Consensus
US	27.3	0.4	-2.5	-2.4	2.2	2.7	2.7	3.1
UK	5.1	0.7	-4.6	-4.5	1.1	1.2	2.5	1.8
Eurozone	25.8	0.6	-3.9	-3.8	1.2	1.2	1.6	1.5
Japan	9.3	-0.7	-5.7	-5.7	1.5	1.4	1.6	1.4
Australia	1.9	2.5	0.9	0.9	2.7	2.7	3.0	3.3
OECD	69.5	0.4	-3.5	-3.5	1.7	1.9	2.1	2.2
China	8.2	9.0	8.5	8.5	9.2	9.6	9.0	9.1
Emerging*	30.5	5.4	1.1	0.7	5.1	5.3	5.7	5.7
World	100.0	1.9	-2.1	-2.2	2.7	2.9	3.2	3.3

Inflation CPI

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus	2011	Consensus
US	27.3	3.8	0.1	-0.4	2.7	2.0	1.0	1.9
UK	5.1	3.6	2.1	2.1	2.2	2.0	2.4	1.8
Eurozone	25.8	3.3	0.3	0.3	0.8	1.1	0.9	1.5
Japan	9.3	1.7	-1.2	-1.2	-0.5	-0.9	-0.8	-0.2
Australia	1.9	4.5	1.8	1.8	2.4	2.4	2.5	2.6
OECD	69.5	3.3	0.2	0.0	1.5	1.3	0.9	1.5
China	8.2	5.9	-0.5	-0.6	4.0	2.6	4.0	2.9
Emerging*	30.5	8.0	4.3	4.2	5.7	4.9	5.3	4.9
World	100.0	4.8	1.4	1.3	2.8	2.4	2.2	2.5

* Emerging markets: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Slovakia, Romania, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

Interest rates

%	Wt (%)	Dec-08	Dec-09	Market	Dec-10	Market	Dec-11	Market
US	27.3	1.00	0.25	0.28	1.00	1.36	2.50	2.72
UK	5.1	2.00	0.50	0.65	1.25	2.09	2.50	3.69
Eurozone	25.8	2.50	1.00	0.72	1.50	1.72	2.00	2.72
Japan	9.3	0.10	0.10	0.51	0.10	0.49	0.25	0.63
OECD	67.5	1.52	0.53	0.51	1.09	1.43	2.00	2.51

Market data as at

16/11/2009

Key variables

FX	Current	Dec-08	Dec-09	y/y%	Dec-10	y/y%	Dec-11	y/y%
USD/ GBP	1.68	1.49	1.66	11.7	1.65	-0.6	1.55	-6.1
USD/ EUR	1.48	1.35	1.50	10.9	1.55	3.3	1.45	-6.5
JPY/ USD	89.3	91.1	88.0	-3.4	88.0	0.0	90.0	2.3
GBP/ EUR	0.89	0.91	0.90	-0.7	0.94	4.0	0.94	-0.4
Brent crude	77.7	40.5	75.0	85.2	82.2	9.5	83.3	1.4
US output gap %GDP	-6.3	-4.1	-8.2		-7.1		-4.7	
Unemploy. %	10.2	6.9	10.3		10.1		8.9	

Source: Schroders, Datastream, IMF, Consensus Economics (November 09)

• Our forecast for global growth have been raised by 0.5% since the last CMF with the world economy now expected to grow by 2.7% next year. For 2011, we expect global growth to exceed 3% for the first time since 2007. The upgrade has largely been driven by a better than expected GDP performance in the third quarter and an increase in the contribution expected from the inventory cycle. Forecasts for the emerging markets have also been raised in response to the upgrade to OECD growth and the continued strength of China.

• The W shape growth profile. After the downleg in 2008 and 2009H1, the initial recovery is driven by the industrial sector and stronger government spending. The main impact of this is being felt now and should last until 2010 Q1. In mid-2010, we would look for growth to slow as the inventory cycle fades while final sales are constrained by ongoing de-leveraging in the household sector, tax increases and higher commodity prices. Thereafter, growth is expected to pick-up again as the corporate sector begins to recruit and employment rises following the improvement in profitability.

• After falling sharply in 2009, headline inflation is forecast to rise in 2010 following the recovery in commodity prices. However, outside commodities, deflationary pressures persist and the US is expected to experience a decline in core inflation (CPI ex food and energy) through 2010. In the absence of further gains in commodity prices, the slack created by the downturn keeps downward pressure on inflation such that the headline rate falls back in 2011. The pattern in the EM economies is different as there is less spare capacity and in economies like China, excess money growth is likely to push inflation higher in 2010 and 2011.

• Interest rates in the US and Europe are not expected to rise until September 2010 as the central banks pursue a cautious exit strategy from the ultra-loose period of monetary policy. By historical standards, rates stay very low through out the forecast period.

Growth: US GDP forecast raised to 2.2% for 2010 from 1.6%. In 2011, we look for growth of 2.7%, close to trend.

• Amongst the OECD, the weakest growth forecasts for 2010 can be found in Europe with the UK (1.1%) suffering from the after effects of the banking crisis and the Eurozone (1.2%) being held back by the strength of the Euro. Similarly, yen strength weighs on Japan which records growth of 1.5% in 2010.

• OECD activity now forecast at 1.7% in 2010 compared to a previous estimate of 1.3%.

• Emerging market growth has begun to pick up sharply led by China, which is now expected to grow by 8.5% this year and just over 9% in 2010. Overall, the emerging markets are expected to accelerate to 5% in 2010 from 1% in 2009.

Inflation: Global Inflation picks up in 2010 to 3% in line with higher commodity prices, however core rates drift lower as the output gap squeezes wages and pricing power. Consequently, headline inflation falls in 2011 in the OECD. By contrast, EM inflation is expected to remain high in 2011 as there is less spare capacity and the liquidity overhang increasingly feeds into consumer prices.

(Note: We use forward futures rates for commodity price assumptions).

Monetary policy: Central banks are expected to leave rates at current levels until September of next year when the Federal Reserve is expected to raise rates by 25 basis points (bps). The Bank of England and ECB are then expected to follow. Such a prolonged period of very low interest rates is consistent with concerns about the strength of the recovery and the banking sector, the need to offset tighter fiscal policy and low inflation at the core level. Policy is set to tighten in the EM with China expected to revalue the CNY in 2010H2.

Currency: The USD is expected to remain weak in 2010 as investors use the dollar to fund carry trades into higher yielding currencies. An outcome which the US authorities do not resist given the persistence of the current account and budget deficits. The USD stages a minor recovery in 2011 as the Fed continues to tighten.

• The GBP is expected to weaken slightly over the forecast period to reflect the combination of a loose money/ tight fiscal policy which is more pronounced in the UK than elsewhere. Weakness is most marked against the EUR and JPY.

26th November 2009

II. Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

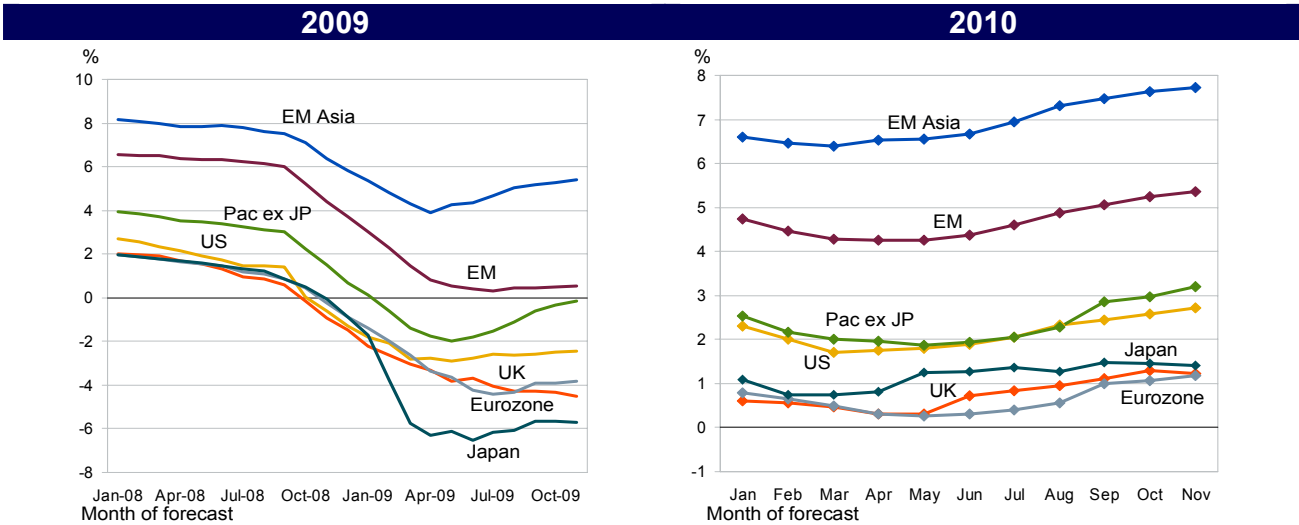
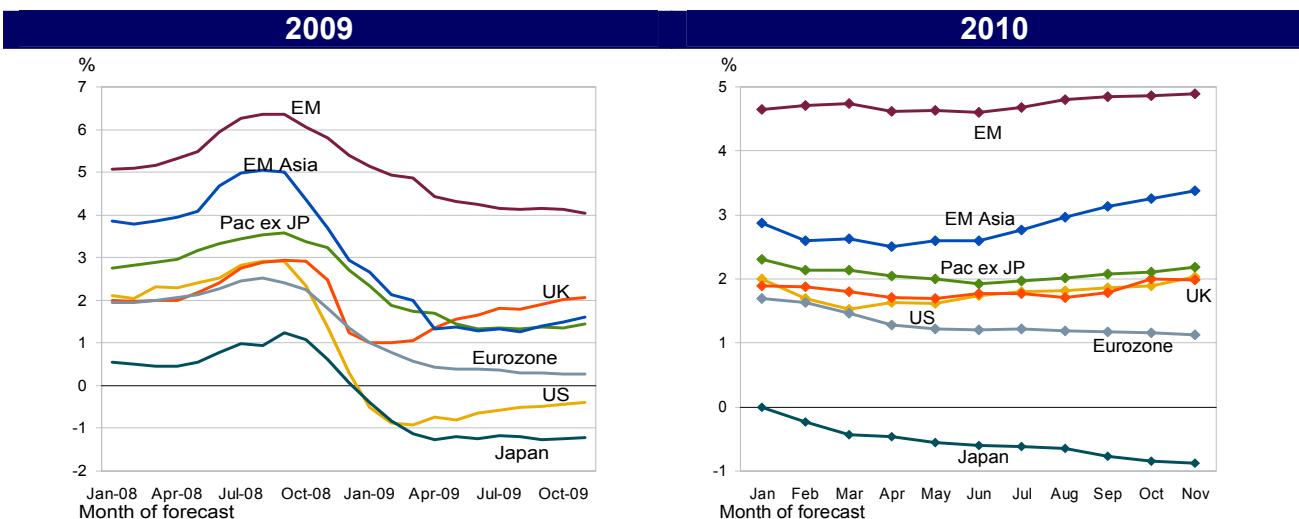


Chart B: Inflation consensus forecasts



Source: Consensus Economics (Nov. 09), Schroders
 Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
 Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand
 Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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