

Schroders

Economic and Strategy Viewpoint

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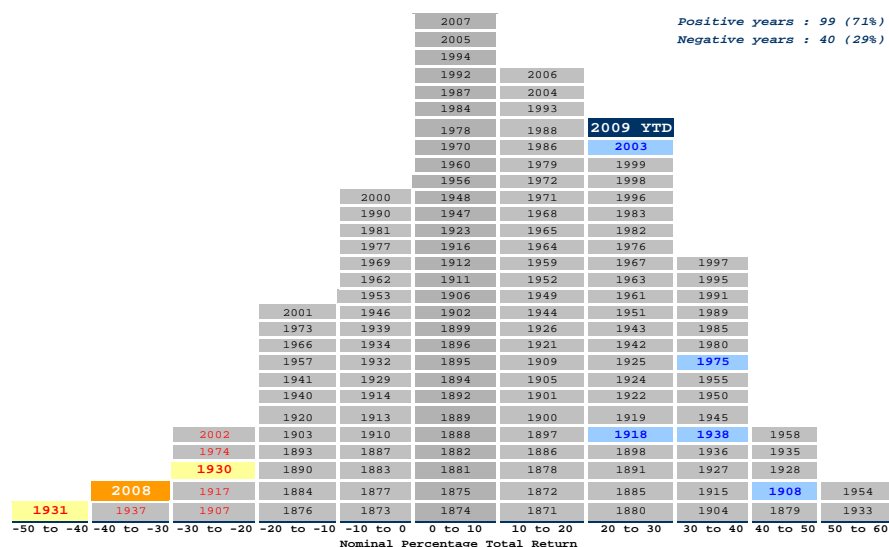
Global: Themes for 2010

- Markets experienced a reversal of fortune in 2009, rebounding after the catastrophe of 2008. Such turnarounds do not happen often, just six times since 1871 (see chart). The latest was set up by a bout of extreme pessimism in March, the point at which bonds and equities had discounted depression.
- We argue that valuations still leave scope for the rally to continue into 2010. Such a move would be helped along by the combination of low interest rates and rising profits – a continuation of the sweet spot - one of our themes for 2010.
- Another key theme is economic divergence: the gap between the developed and emerging markets which should mean that capital continues to flow into the latter in search of higher growth. The risk is not a reversal, but an excess of liquidity resulting in bubbles or overheating.
- Later in the year, markets can be expected to focus on the impact of tighter liquidity as central banks gradually exit from the very loose monetary policies deployed to head off the crisis. Although policy makers will move gradually, bond yields are likely to come under pressure and we would be looking to rotate out of credit and high yield into equities.

Europe: Humbug!

- During this festive period, we are visited by the ghost of credit-crunch past and reminded of how well the world has coped with the greatest economic crisis since the Great Depression. However, we are also reminded that risks remain, and European banks still need to fix their balance sheets.
- We are then visited by the ghost of current deficits as sovereign debt default surfaces as a potential risk, especially with leaders postponing tough decisions.
- Finally, we are visited by the ghost of future austerity, and warned fiscal consolidation must take place. The road to recovery for Europe is icy and hazardous, but we look forward to exploring opportunities with you in 2010. Seasons Greetings.

Chart 1: S&P 500 nominal annual return since 1871



Source: Yale University/ Robert Shiller, Schroders, 17 December 09. 2009 YTD return 24.2%



Global

Themes for 2010

Reversal of fortune

A classic rebound for equities in 2009

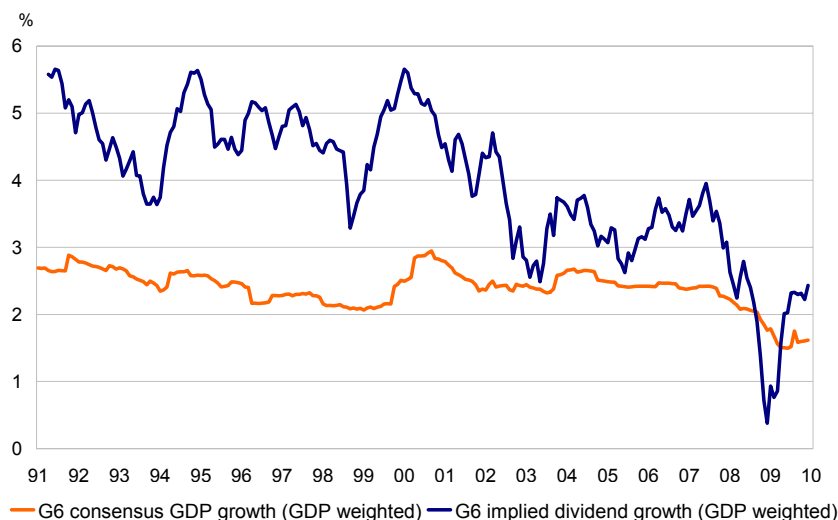
For a while it looked as though 2009 would be as bad as 2008 as markets continued to dive in the first quarter. However, the rally which began in March means that a very bad year has been followed by a very good year for equity market performance. At the time of writing, US equities are up just under 25% year to date and 2009 looks set to be remembered as a classic rebound year.

Such moves are rare, but not without precedent. 2009 will be one of six years since 1871 where a calendar year loss of more than 20% has been followed by a gain of at least 20%, the most recent being 2003 (see chart on the front page). Each of the six has had its own unique characteristics, but a bursting of a bubble, economic turmoil or war played a part in most – sometimes in that order. The main constant, of course, was the ability of fear and greed to drive investor behaviour. Operationally, markets may have been transformed over the past 138 years, but the motives which drive investors remain the same.

Investors became too pessimistic, creating scope for a rally as a depression failed to materialise

Back in March this year, markets had discounted another Great Depression. Bond markets were priced for ten years or more of deflation and the long run implied rate of dividend growth in equity markets was approaching zero, an unusual occurrence since 1991 (see chart 2). Expectations, which at the time did not seem unrealistic, did not require much in the way of better news to turn more positive.

Chart 2: Implied dividend growth and consensus GDP forecasts



Source: Thomson Datastream, Consensus Economics (Dec.), Schroders, 21 December 09
 Implied growth assumes equity risk premium (ERP) of 3.5% for each G6 country. G6: US, UK, Japan, Germany, France & Italy.

Once investors had regained visibility on the economy and corporate earnings, they were prepared to take advantage of valuations and drive markets up. The markets began to behave according to type by discounting the economic recovery ahead of the event. Today, markets are holding their highs as investors debate the shape of the recovery in 2010.

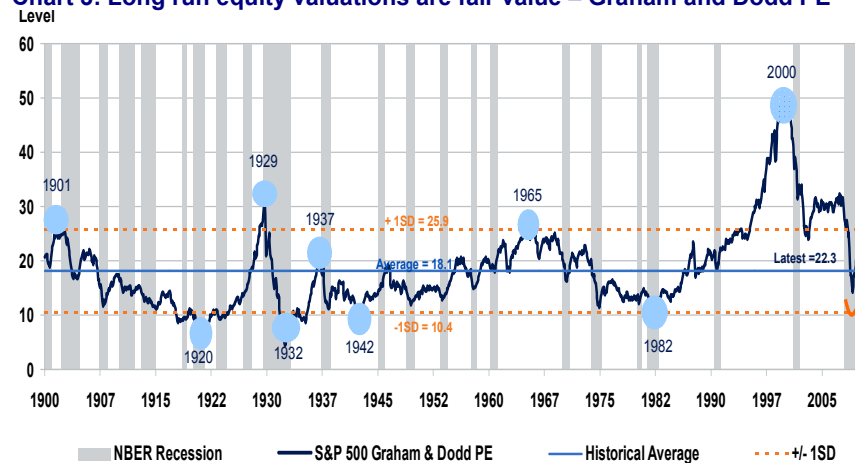
Can history provide us with a guide to what happens after a rebound year?

The evidence shows that in four of the five years after the rebound, equity markets continued to perform and deliver double digit returns. The exception was 1939 when investors had more to worry about than the economy. Bearing in mind the rather small sample, the evidence is encouraging, but have markets already moved too far too fast?

Despite the rally, valuations in equity and credit markets are reasonable

Risk appetite has certainly risen, yet looking at valuations we would not say that equities or credit are expensive. The Graham and Dodd PE has moved above average but remains within its fair value zone, implied dividend growth by equity markets is not excessive and credit spreads, although considerably tighter, are still at the higher end of historical experience.

Chart 3: Long run equity valuations are fair value – Graham and Dodd PE



Graham & Dodd P/E10 ratio is based on the S&P500 price divided by average earnings per share of last 10 years.

Source: Yale University, NBER, DataStream, Schroders, 21 December 09

Macro forecast sees continuing recovery and low interest rates...

Against this backdrop, risk assets should perform well as long as the macro backdrop remains supportive. That primarily means no double dip and a return to recession allowing a measured exit strategy on the part of the authorities.

We gave a detailed account of our macro view in the November Viewpoint¹ which, notwithstanding the risks, is a picture of a world economy being driven by a combination of policy support and the emerging markets. Allowing for a modest slowdown around mid-year as the boost from the inventory cycle fades, we see the rise in US corporate profits as providing a foundation for stronger employment and capital spending. The recent improvement in the Employment report was in our view no flash in the pan as, having over reacted earlier in the year, companies have reappraised the outlook and now find they no longer need to cut costs as aggressively. Productivity growth in the US has been extraordinary, but probably unsustainable. In the meantime, profits should continue to rise with an increase of 28% forecast for 2010.

Interest rates are forecast to remain at current levels in the US, Eurozone, Japan and the UK through to September 2010 as central banks recognise they cannot risk tightening too early and push the world economy back into recession.

¹ See Schroders Economic and Strategy Viewpoint 30 November 2009

From a strategy perspective, several themes emerge from this outlook.

1. The “sweet spot” continues

...allowing the sweet spot to continue

The combination of further gains in profits and the continuation of low interest rates indicate that the “sweet spot” for markets should persist. Equities should make further gains as the recovery in earnings comes through ahead of expectations. For much of the first half of the year, bonds, particularly credit will remain supported as investors continue to move out of cash in pursuit of yield.

The principal threat to this outlook would come from an increase in inflation. The first quarter of 2010 is almost certain to see headline inflation rates in the US and Europe rising above 3%. However, this increase is solely driven by higher commodity prices, the base effect from a year ago when crude oil prices (Brent) fell to \$45 per barrel. Consequently, with core rates remaining subdued we would see this as temporary and would expect markets and central banks to look through the increase. In the US, break-even rates have been rising and at 2.5% would seem to be well placed to withstand a temporary pick up in inflation (see chart 4).

Chart 4: US bond yields and inflation expectations



Source: Thomson Datastream, Schroders, 21 December 09

An end to QE

At around the same time as inflation experiences its blip up, markets will also need to adjust to the ending of quantitative easing (QE) in the US and UK. Both are scheduled to end in the first quarter of 2010, an event widely expected to put upward pressure on bond yields. Simple supply and demand suggests this must be right, but in theory markets should have already anticipated the change given it has been clearly flagged. If there is an impact it is most likely to be felt in the UK where the Bank of England has bought one third of the gilt market.

2. Economic divergence

a. Emerging versus developed

Absence of credit crunch has helped emerging markets out perform

The economic cycle is diverging across regions with the emerging world ahead of the developed. This largely reflects the absence of a credit crunch in the emerging market banking sector which has avoided the excesses found in the US or Europe. For example, according to Bloomberg, Asia accounts for only \$26 billion of \$1058 billion of worldwide losses by banks, brokers and insurance companies incurred since the middle of 2007. Europe and the US account for nearly all of the remainder, a factor which has impaired the ability of monetary policy to stimulate the economy.

Bubble risk as capital continues to flow into the region

Consequently, the superior growth rate of emerging over developed economies is set to persist with the former accounting for more than half of global GDP growth in 2010 and 2011. In response, investors seeking higher growth will continue to direct capital into the emerging world, supporting emerging market currencies and asset prices.

The threat to this story is that too much capital chases too few assets and we get bubbles in some of the main markets. Higher consumer price inflation is another risk as excess liquidity can also flow into the real economy creating overheating. The IMF recently warned Hong Kong about just such an outcome and recommended a series of policy measures that banks could take to cool the property market. Elsewhere in the region, the Reserve Bank of Australia has already begun to raise interest rates and we are likely to see a wider range of efforts by the authorities across Asia to slow liquidity growth in 2010. This would culminate in a revaluation of the Chinese Yuan once China's exports have picked up.

From an investor perspective, this suggests emerging markets assets continuing to outperform other regions, particularly foreign exchange. However, investors need to be wary of the potential for a set back in equities and bonds once policymakers begin to tighten.

b. US versus Europe versus Japan

US pulling ahead

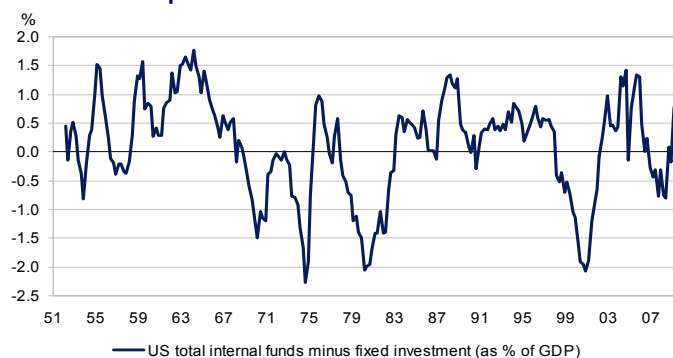
Following the Employment report, it appears that the US is leading Europe, where the Eurozone is experiencing problems on its periphery (e.g. Greece) and Japan, which remains in deflation. Interest rates are likely to be on hold in each for some time, but the perception of a resurgent US should support the USD. The prospect of a weaker euro and yen should support export sectors in Japan and the Eurozone respectively, and we believe that Japanese equities are likely to enjoy the greatest boost.

3. Cash rich corporates

Look for a turn in the capex and M&A cycles

The recovery in profits combined with cuts in expenditure has provided a big boost to US company cash flow such that internally generated funds now exceed investment by more than 1% of GDP (see chart 5). Spare capacity means that companies will not be in a hurry to spend, however orders for durable goods have improved and we would look for a gradual pick-up in capex as we move through 2010. Another beneficiary of stronger corporate cash flow is likely to be mergers and acquisitions activity (M&A) as firms begin to focus on future growth opportunities and the benefits from consolidation.

Chart 5: US corporate sector is cash rich



Source: Thomson Datastream, Schroders, 22 December 09

From an equity perspective, this would primarily point to outperformance by the industrials and technology sectors, which would benefit from the increase in capex spend. Recruitment firms and investment banks may also benefit from higher employment and M&A.

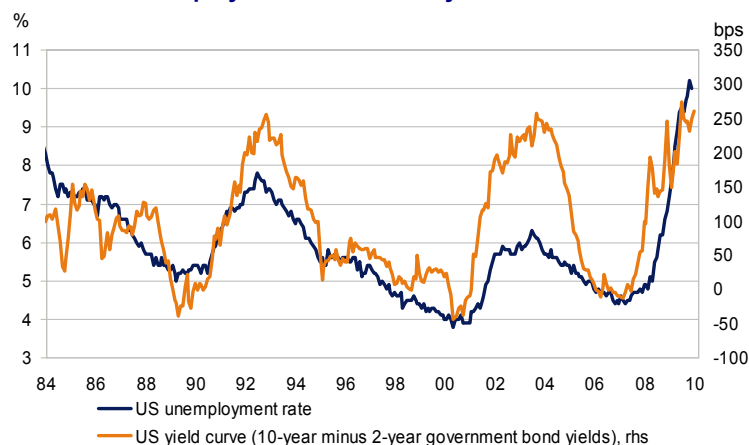
The exit strategy beginth

4. Tightening liquidity

Rising interest rates in parts of Asia and an end to Quantitative Easing will mark the start of a gradual exit from ultra loose policy on the part of the central banks. Short-term interest rates in the major economies remain low for most of the year in our base forecast, but prior to the first rise we will see less liquidity support for banks. For example, the ECB has just held the last of their special auctions of 12-month money. In March next year, they will hold the last auction of 6-month funds. Although the Fed has announced they will extend the TALF² to October, the general theme will be one of tightening liquidity.

Consequently, later in the year we can expect bond yields to begin to rise and for riskier borrowers to come under pressure. This would mean a more cautious stance on credit. The central banks are likely to make this process as measured as possible, but we can still expect some casualties. In addition, yield curves should begin to experience a bear flattening, with 2-year yields rising faster than 10-year. This would be consistent with a fall in unemployment (chart 6).

Chart 6: US unemployment rate and the yield curve



Source: Thomson Datastream, Schroders, 22 December 09

5. Sterling crisis

One economy that could be seen as a riskier credit is the UK which has been put on watch by the ratings agencies. The threat of a hung Parliament and a lack of credible fiscal action presents a challenge to both gilts and sterling. It could be argued that sterling has already fallen and so the risk is discounted, however as our analysis of the Pre Budget Report (PBR) makes clear the UK government still has some distance to travel to deliver a credible fiscal strategy (see below).

² TALF: Term Asset Backed Securities Loan Facility
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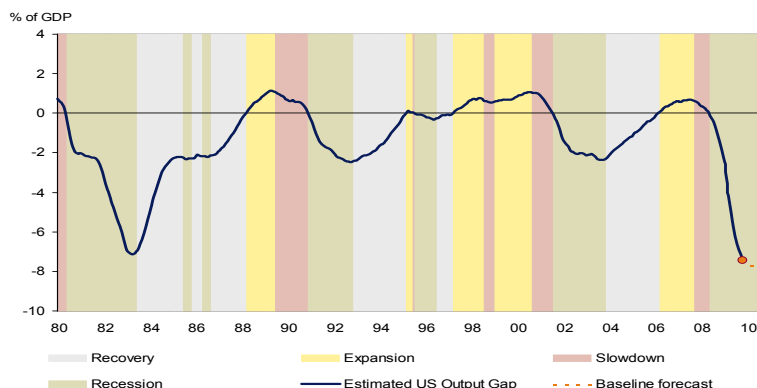
Rotation from credit to equities ahead

Cycle points toward change of tack in 2010

Our analysis³ of asset allocation and economic cycles suggests that we are likely to move from the recession to the recovery phase in the first half of 2010. Output will begin to grow at a pace which can absorb the slack in the economy. The recovery phase is one where risk assets perform well in absolute terms and relative to government bonds. On our analysis, returns are not as high as in the current recession phase, but still significantly positive (see table 1).

The main difference is that whilst equities and credit give similar returns in the recession, in the recovery phase equities outperform. This would tie in with the view expressed above that 2010 will see a rotation out of credit and into equity markets.

Chart 7: Schroders Economic Cycle framework



Source: Schroders, DataStream, 23 December 09

Table 1: Asset performance by stage of the economic cycle

Phase/ Asset	Statistics	Recovery	Expansion	Slowdown	Recession
Equity	Excess return*	8.6	8.8	-8.1	10.0
	Volatility	13.7	12.4	17.4	14.5
Government Bonds	Excess return	1.3	-1.0	-0.2	1.7
	Volatility	6.9	4.7	8.7	8.8
High Yield	Excess return	6.4	1.8	-10.3	13.5
	Volatility	6.4	4.0	9.8	8.5
Investment Grade	Excess return	5.4	2.9	-1.9	7.0
	Volatility	5.9	4.9	10.2	8.9
Commodity	Excess return	1.9	16.2	7.7	1.0
	Volatility	15.0	20.5	22.7	17.3
Average (global asset)	Excess return	5.0	5.2	-2.6	7.1
	Volatility	5.9	5.8	8.3	6.6

Data: Equity S&P 500 TR & US 10yr Govt. bonds from 1950 to 2009, Lehman US High Yield from 1983 - 2009, Lehman US Corporate Investment Grade from 1973 -2009, S&P GSCI commodity (1970 -2009).
 *All risk return figures are in % annualised excess of cash. Average of global assets is equal weighted of all five assets.

Source: Datastream, Schroders

³ For more details see Schroders Global Market Perspective Q4 09

Europe

Humbug!

Public finances are back in the spotlight following the Dubai World incident last month. A spate of sovereign-debt downgrades did little to bring festive cheer, forcing Ireland and Greece to make new-year fiscal resolutions to cut their government deficits.

In the UK, Prime Minister Gordon Brown decided UK bankers have been too naughty this year to deserve all of their bonuses, introducing a temporary 50% super-tax on bonuses exceeding £25,000. French President Nicolas Sarkozy agreed and confirmed that bankers in France would also face a similar policy.

Meanwhile, UK Chancellor Darling played the classic pantomime character, hiding future fiscal tightening deep within his Pre-Budget Report, leaving economists shouting: "IT'S BEHIND YOU" – or at least after the next general election. Nevertheless, the act seems to have worked providing good news for Labour as they make up ground in political polls heading into the new year. However, a tight election next year and the risk of a hung parliament spell trouble for gilts in 2010.

Ghost of credit-crunch past

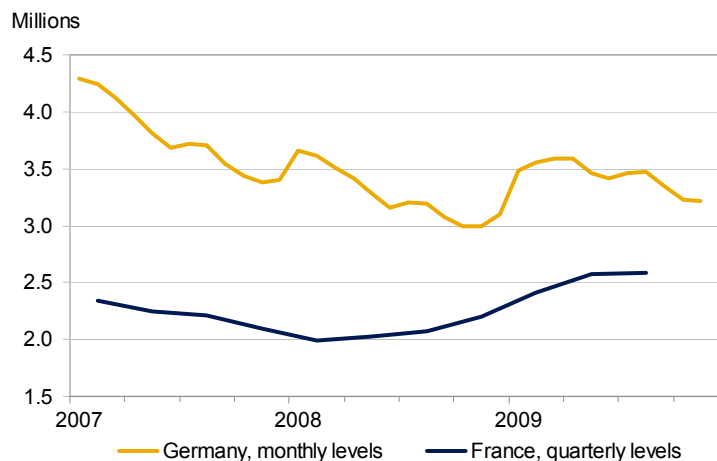
Most of Europe is out of recession, and the recovery is well underway in France and Germany...

As 2009 draws to an end, we look back at the events over the past 18 months and breathe a sigh of relief. Europe, nay the world, faced the greatest economic crises since the Great Depression, and yet, somehow, all is calm once more.

Most of Europe is out of recession and the recovery is well underway in France and Germany. Remarkably, the impact on the real economy has been far less damaging than expected. Eurozone output as measured by GDP fell 5.1% from its peak during this crisis, and yet unemployment has risen by a mere 1.7 percentage points.

Germany's labour market has been particularly more flexible than its European counterparts, thanks to the government subsidised part-time work scheme - Kurzarbeit. Chart 8 shows how far the level of German unemployment has fallen since March, while French unemployment appears to be close to its peak.

Chart 8: Unemployment levels



Source: DataStream, 23 December 09

... Mrs. Merkel will be celebrating a good year...

Mrs. Merkel will certainly be celebrating over the festive period. Election victory with her preferred coalition partners, out of recession earlier than most of Germany's competitors, and now, unemployment falling far sooner than expected - a perfect end to a terrible year? Not quite. There is the little matter of Germany's banking sector, which has yet to face up to the toxic assets still on their balance sheets.

... however, European banks could still face more write-downs in 2010.

The Bundesbank last month warned German banks that the next wave of write-downs from loan book losses could reach €50 to €70 billion as the default rate on lower tier companies exceeds 14% in the US and 12% in Europe. The Bundesbank stated that it feels that most losses from sub-prime securities are now in the open, although it expects further write-downs from collateralised debt obligations (CDOs) – mostly tranches of mortgage debt packaged securities – adding a further €10 to €15 billion of losses.

However, Dominique Strauss-Kahn, head of the International Monetary Fund, warned that "there are still large hidden losses: perhaps 50% tucked away in balance sheets. The proportion is higher in Europe than in America. The history of banking crisis, notably in Japan, shows that there won't be healthy growth again until the banks have cleaned up completely."

Will the ghosts of the credit crunch come back to haunt European leaders in 2010? The last of the European Central Bank's 12-month liquidity auctions has come and gone and so liquidity in Europe will become more constrained as we go through next year. In addition, as activity picks up, companies will be looking for more working capital, only to find that there may not be enough to go around – potentially forcing profitably viable firms to become insolvent – adding to write downs as the Bundesbank warns. European banks are running out of time and may yet need further support from governments in the form of asset insurance schemes (like that in the UK), or as a worse case scenario, nationalisation.

Ghost of deficits current

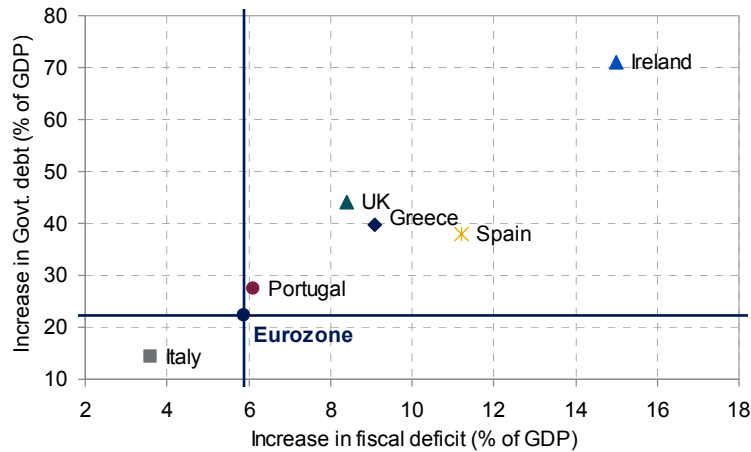
Meanwhile, governments are counting the cost of the crisis...

Though the recession has ended, the cost of government intervention is still being counted, with bond vigilantes waiting on the sidelines. The European Commission has continued to call for credible plans to bring public deficits back under control, though leaders continue to argue that it is still too soon to remove fiscal support.

Very poor public finances are slowly being recognised in Europe, with markets beginning to pay close attention to the poorest performers. Spain and Portugal have had their 'outlook ratings' downgraded by Standard & Poor's from 'stable' to 'negative', while Greece had all the major agencies queuing to downgrade its sovereign debt.

The deterioration in public finances in Europe has been stark. Based on the European Commission's forecast, Chart 9 on the next page shows the expected increase in government deficits between 2007 and 2011 along the X-axis, plotted against the forecasted increase in government debt along the Y-axis. The chart shows total Eurozone debt is expected to rise by 22% of GDP, while total government deficits are forecast to increase by just under 6 percentage points of GDP. The worst offenders within the union and the UK are also plotted, highlighting the reasons behind the recent rating agency downgrades.

Chart 9: Forecasted fiscal deterioration (2007-11)

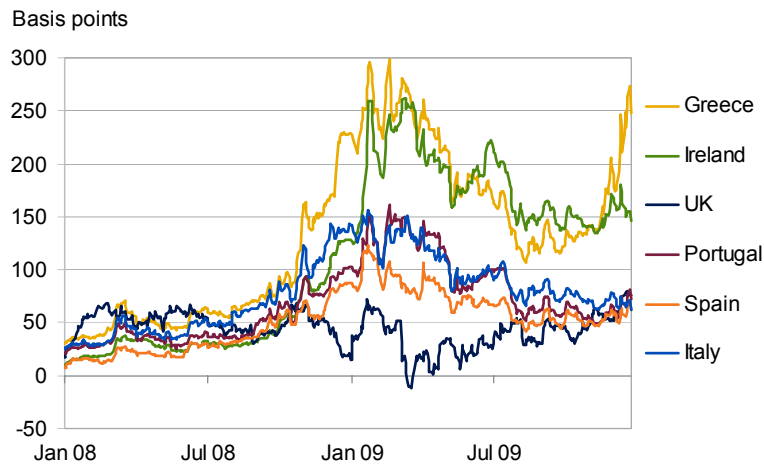


Source: European Commission Autumn 2009 Forecast, Schroders, 23 December 09.

... with poor performers being punished by bond investors.

Government bond markets are now demanding a premium for holding debt issued by these worst performers. While Ireland stands out as one of the most severely hit by the recession, Greece has recently been singled out from the pack as least favoured issuer. The spread between generic 10-year government bond yields for Greece relative to Bunds has widened significantly lately, currently over 270 basis points, and quickly approaching the peak in spreads seen at the height of the crisis in February (chart 10). It is also worth noting from the below chart that the spread for UK Gilts has also been rising, and at the time of writing has risen above the spreads for Italy, Spain and Portugal. This may be a response to the expected end of quantitative easing in the first quarter of 2010, but also a reaction to Pre-Budget Report this month.

Chart 10: Generic 10yr government bond yields over Bunds



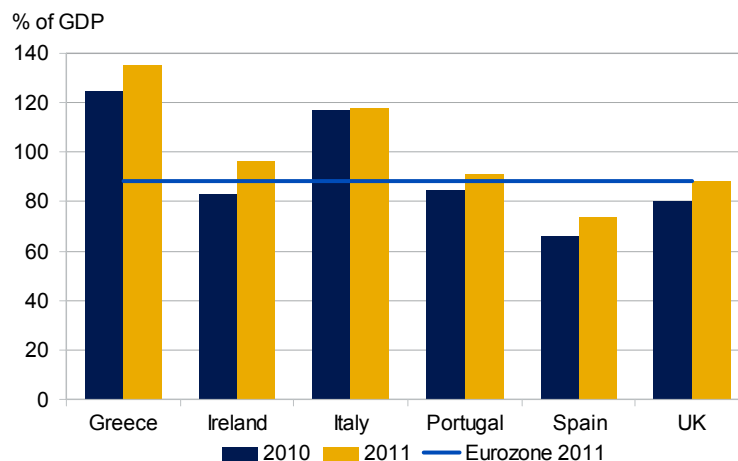
Source: DataStream, Schroders, 22 December 09

Returning to the worst performer, why is Greece being punished more than say Ireland? The simple answer is the relative starting position of the two. Ireland was running a small budget surplus in 2007 whereas Greece was in breach of the Maastricht Treaty 3% deficit rule even during the best of times. In addition, Greece went into this crisis with general government debt at over 95% of GDP while Ireland's government debt was just over 25% of GDP, well below the Eurozone average of 66% of GDP.

Greece appears at risk of default...

Looking ahead, it becomes clear that markets are right to be concerned about Greek public finances and even prepare for the possibility of Greece defaulting on its sovereign debt. Chart 11 shows the European Commission's forecast for debt levels over the next two years, with the Commission expecting Greece's debt to top a mammoth 135% of GDP in 2011.

Chart 11: Government debt forecast



Source: European Commission Autumn 2009 Forecast, Schroders, 23 December 09

When considering the probability of Greece defaulting, we have to take into consideration the size of its short-term liabilities and its ability to fund them. The European Commission expects Greece's government debt interest payments to reach 6.1% of GDP in 2011, rising from an estimated 4.9% in 2009. At the same time, the Commission forecasts tax revenues to fall slightly from now to 37% of GDP in 2011. This means that Greece's potential liabilities could rise from 13% of its tax revenues to over 16% of its revenues – a dangerously large amount of liabilities to service.

... however, we expect help from the rest of Europe should Greece run into difficulty.

Greece is in a terrible state and we currently place a 15% probability that some type of event risk takes place. However, we also place a 90% probability that Greece would receive assistance from the rest of Europe, despite the European Commission's rule of no bail-outs. Mrs. Merkel stated earlier this month that "...what happens in a member country influences all others...that is why we all share a common responsibility", indicating that at least Germany would be prepared to lend a hand. Therefore, the risk of actual default is far lower, approximately 1.5%, over a two year horizon. How does this compare to the market? At close of play on the 21st of December 2009, 2-year Greek sovereign credit default swaps (CDS) are trading at approximately 207 basis points – or placing a probability of just over 2% of default per year over the next two years.

European binge borrowers were forced to reassure bond investors this month...

Ghost of future austerity

Despite the threat of agency downgrades and higher borrowing costs, European ministers of finance have been slow to reassure markets. Arguably, Germany led the way by introducing legislation earlier this year that guaranteed a balanced structural budget within the next 6 years. However since then, the new coalition has been more focused on tax cuts than rather than tightening policy. In its Draft Budget, the German government confirmed €10 billion worth of tax cuts in 2010, but left out details of how fiscal consolidation would be achieved in later years. We however expect spending cuts to be announced next year after the important North Rhine Westphalia Bundesrat (upper house) elections in May 2010.

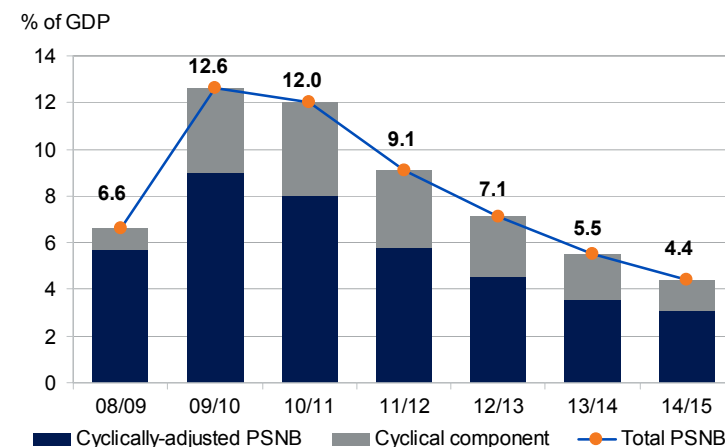
Ireland's minister of finance Brian Lenihan delivered a convincing Budget speech this month with a plan to reduce Ireland's budget deficit to just 3% of GDP by 2014, starting by imposing 5-15% public sector pay cuts depending on individual salaries. In contrast, following the S&P and Fitch downgrades, Greece's finance minister Papakonstantinou rushed a statement promising tax efficiency reforms and a cut in state spending by 10%, with an aim to cut its budget deficit from 12.7% to 8.7% of GDP in 2010. However, after being pressed domestically by trade unions, Papakonstantinou admitted that public sector pay would rise in real terms in 2010.

... though UK Chancellor Darling had other plans, providing little detail on future fiscal tightening.

Meanwhile, UK Chancellor Alistair Darling announced a flurry of new tweaks and policy changes in his Pre-Budget report (PBR), but delivered a report that was essentially neutral for both public finances, and the economy. More support for lower income families may help boost consumption at the margin, but the re-instatement of VAT at 17.5% in January 2010 and the new 50% top rate of tax are likely to offset most of the upside gains. The much derided tax on banker's bonuses grabbed all the headlines, but the lack of detail on how the current assumed fiscal consolidation would take place left many uneasy.

Chart 12 shows the Chancellor's forecast for government borrowing, and a breakdown between how much of current borrowing is due to the recession (cyclical component), and how much is assumed to be caused by structural changes to the economy (cyclically-adjusted). The concern is that most of the deficit this year and over the forecast horizon is caused by structural factors, and so the recovery in GDP growth will not lead to the deficit falling much.

Chart 12: HMT government deficit forecast



Source: HM Treasury, Pre-Budget Report 2009

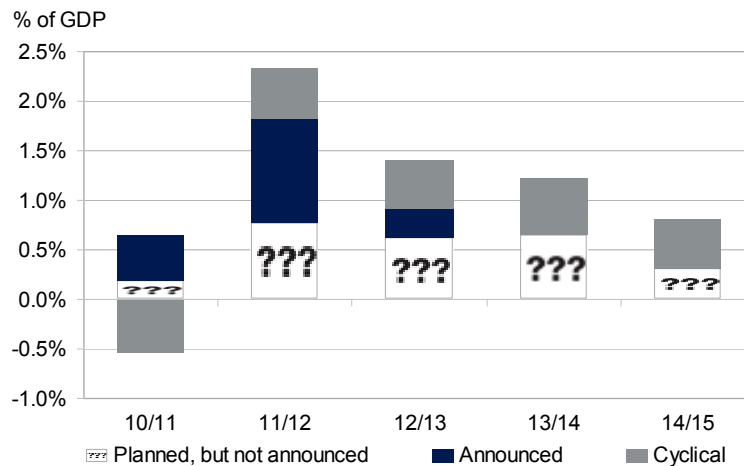


The key challenge for the UK will be reducing this structural deficit, which can only be achieved in the short-term by increasing taxes, cutting public spending, or widening the tax base. Structural improvements to the economy take many years and arguably, chastising the financial services sector, which is a significant tax contributor to the exchequer, is not the way to improve trend growth.

The UK will have to overcome its large structural deficit, through increasing taxes, cutting spending or widening the tax base.

Given the UK's need to reduce its structural deficit, the lack of detail in the PBR on how the Chancellor intended to meet his target did not go unnoticed. We have calculated the forecasted change in annual government borrowing (fiscal tightening when positive), but once again broken this down into what the Chancellor assumes will be cyclical, and structural. However, we have gone further by calculating the fiscal policy changes announced up until PBR2009, and then broken down the structural tightening (tax rises and spending cuts) into 'announced' and 'planned, but not announced' measures (chart 13).

Chart 13: Missing deficit reducing policies



Source: HM Treasury, Pre-Budget Report 2009, Schroders

The above means that we can estimate how much further fiscal tightening needs to go, just to meet the Chancellor's own forecast. If the Chancellor is to meet his forecast, he would need to announce an additional 1.6% of GDP (£25 billion) tightening for the next three fiscal years. This is roughly equivalent to raising the basic rate of income tax by two to three pence in the pound permanently.

When should we expect the Chancellor to come clean? We may have to wait until all the snow has melted away, and we start to hunt for those fiscal Easter eggs – after the general election expected in spring.

Seasons greetings one and all.

And now we leave you dear investors pondering the messages from our three ghosts. The road to recovery for Europe is icy and hazardous, but we look forward to exploring opportunities with you in 2010. Seasons greetings.

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 to be 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

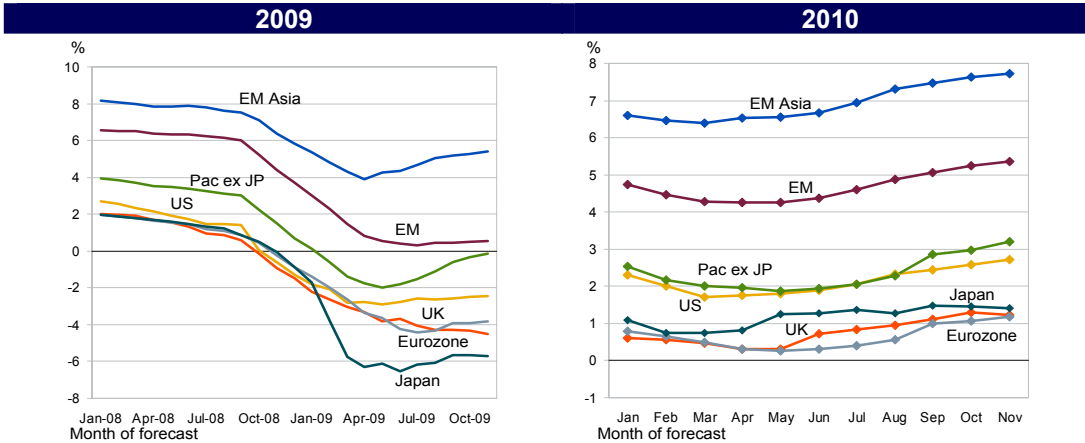
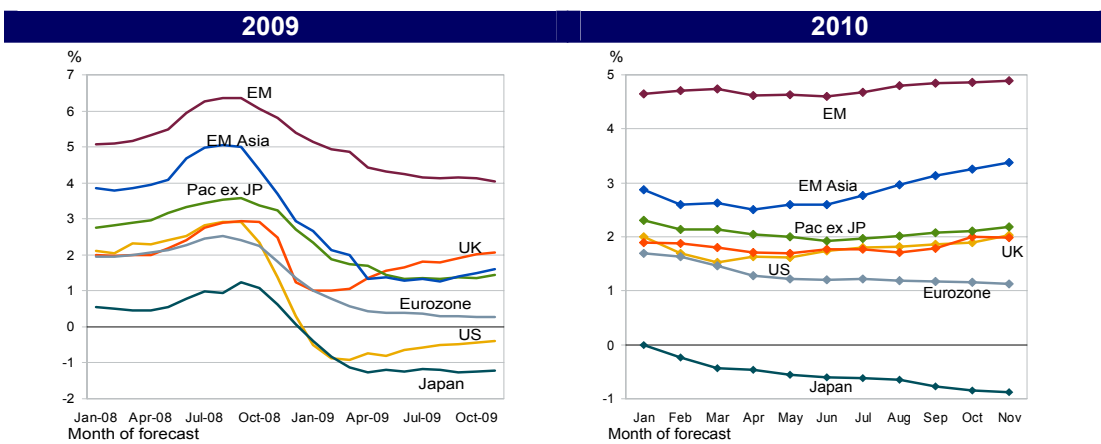


Chart B: Inflation consensus forecasts



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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