

# Schroders

## Economic and Strategy Viewpoint

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### Global: World economy continues to defy the pessimists (page 2)

- Global economic activity continues to strengthen and surprise on the upside led by the US and emerging markets. The rebound in corporate profits, rally in financial markets and ongoing resilience in the emerging world have played a role, underpinned by record policy stimulus.
- The performance of the US is particularly striking given the past experience of economies recovering from a financial crisis (see chart below). There are considerable challenges ahead, but we see the performance to date as testimony to the rapid policy response and flexibility of the economy. The US has also benefitted from possessing the world's reserve currency which has meant that funding has continued to flow in without the need for higher interest rates. The Eurozone, meanwhile continues to struggle.
- Our asset allocation model has moved into the recovery phase of the cycle, an environment where the economy is in a sweet spot of rising growth and subdued inflation. Real assets, equity and property, tend to outperform during this phase, as markets focus on rising earnings and rents. Anticipation of tighter monetary policy means that bond performance begins to slow as yield curves flatten.

### Eurozone: Crunch time (page 9)

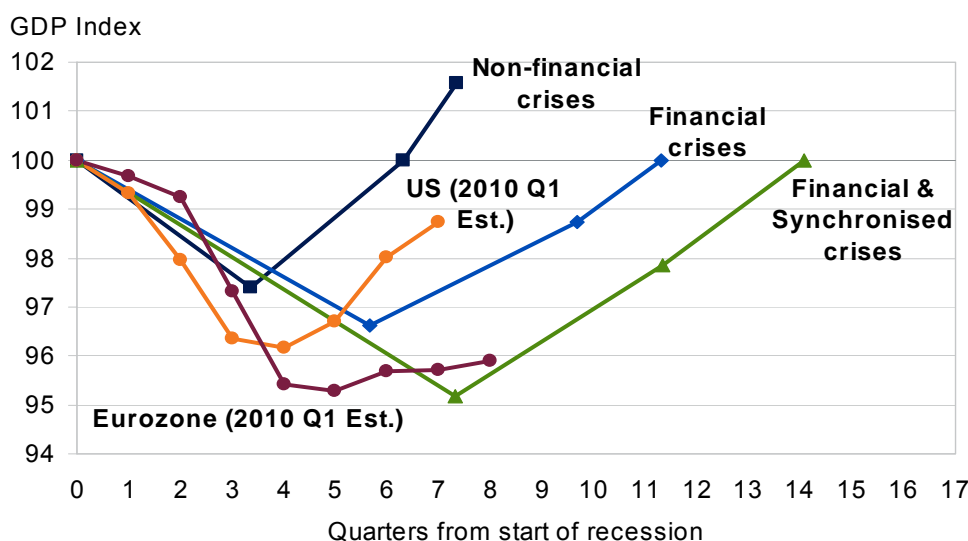
- Another month, another crisis. This time it is the grounding of European flights following a volcanic eruption in Iceland. The situation now appears under control, which is more than can be said about the Greek crisis. Greece has now officially requested a bail out, and funding is imminent. But as long as some doubt remains, bond vigilantes continue to test Greece's resolve.

### UK: Inflation forecast revised to incorporate 19% VAT (page 16)

- We have updated our UK inflation forecast to take into account a potential hike in VAT to 19%. Though this has not been officially announced, we are happy to take the plunge as the first City forecasters to make this assumption.

### US is performing better than expected, but the Eurozone struggles on

Average experience of industrial countries by cause of recession



Source: IMF WEO (April 2009), Thomson Datastream, Schroders, April 2010  
Based on 122 observations of recession and recovery in industrial countries since 1960



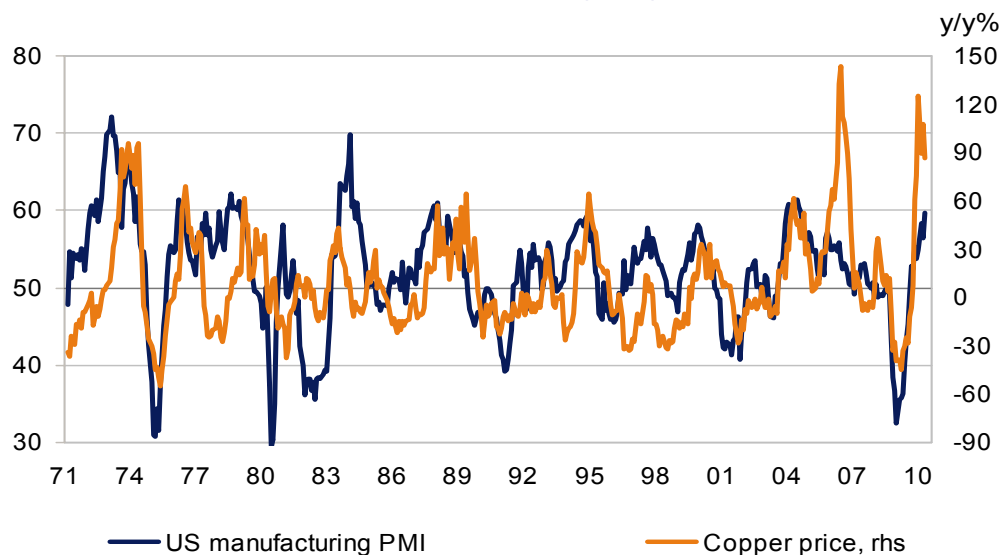
# Global

**Activity continues to strengthen... as the recovery broadens**

## World economy continues to defy the pessimists

Against a backdrop of continuing concerns about rising government budget deficits, tougher financial regulation and the return of protectionism, global economic activity continues to come in stronger than expected. Indicators of global activity such as the regular Purchasing Managers Indices, or the less conventional copper price are buoyant (see chart 1).

**Chart 1: US ISM index and copper prices surge higher**



Source: Thomson DataStream, 21 April 2010

Estimates for US GDP growth in the first quarter are now running at 4% (q/q annualised) following a revival in consumer spending and continued expansion in the industrial sector. Capital spending in the business sector is also growing, having picked up at the end of last year and, along with the better tone to consumption, indicates that the recovery is broadening beyond the inventory cycle.

**Emerging economies are booming again, but Europe is lagging**

In Japan, growth forecasts are also being revised up as business confidence rises and across Asia generally, growth is surprising on the upside as trade revives. Singapore achieved remarkable quarterly GDP growth of 32% annualised in the first quarter and China beat expectations by growing at 11.9% y/y in the first three months of 2010 with exports rising 29% y/y. Elsewhere, in the emerging markets activity in Brazil and India remains robust.

The only area not to share in the general upgrade to activity is the Eurozone where the labour market and consumer spending remain sluggish. Part of this may relate to poor weather which depressed activity at the start of the year. Fiscal tightening has also moved up the agenda as a result of the situation in Greece. Similar concerns are keeping UK forecasts on hold as investors focus on the general election. Whoever wins it is clear that the UK will be facing several years of tightening fiscal policy.

Overall the world economy has continued to defy the pessimists and even with our relatively constructive view of the world economy, it looks likely that we will be revising up our forecasts for global growth for 2010 at our next quarterly review in May.

## Factors driving the recovery

***Stronger profits, the rally in financial markets, ongoing resilience in the emerging world and policy stimulus have all played a part in the recovery***

We would identify four areas of support for the recovery

- The first would be the benefit of the strong recovery in corporate profits. The macro numbers have improved as US firms have started to deploy their cash flow by raising capex and beginning to recruit again. Although this has been accompanied by a rise in unemployment as firms cut costs, the fact that it was delivering strong productivity and profits gains indicated that the pace of cost cutting would moderate and eventually cease. Importantly, unemployment is a lagging indicator whilst profits lead economic activity.
- Second, is the stabilisation and recovery in financial markets. Although some see this as misplaced (a “distrusted rally”), the revival has increased household wealth and allowed companies access to capital. From a macro perspective, this helps both consumer and corporate spending.
- The ongoing strength of the emerging world has also played a part with the Asian and LatAm economies rapidly regaining the output lost in the downturn and proving able to withstand the drop in global trade.
- Fourth, underlying all these factors has been the continued level of policy stimulus, with both fiscal and monetary policy providing significant support.

## Recessions and recoveries compared

***The US is performing better than past experience would suggest***

These factors are reflected in the performance of the US relative to previous cycles. Using analysis from the IMF<sup>1</sup>, we created a template for the path of output in economies during conventional recessions and those caused by a financial crisis.<sup>2</sup> The key feature of recessions caused by a financial crisis is that they tend to be deeper and longer than conventional recessions. This largely reflects the impairment of the policy transmission mechanism as banks restrict credit whilst they focus on rebuilding their balance sheets. Meanwhile, a fall in asset prices prompts a similar period of balance sheet repair in the household sector. Consequently, recovery is slower than in conventional cycles as monetary policy fails to stimulate expenditure.

Whilst downturns caused by financial crisis are worse than the conventional, those which are synchronised tend to be the worst of all with a period of 14 quarters needed to regain the previous level of GDP. Given the global nature of the recent crisis most commentators expected this to be the path followed by the world economy.

Looking at the current performance of the US economy we can see that it experienced a recession which was as deep as past recessions caused by financial crises, although not as bad as a synchronised crisis (see chart on front page). The upturn which began in Q3 last year has been better than history would suggest with the economy about 6 months ahead of the average experience for a recession caused by financial crisis. By contrast, the Eurozone is following a move typical path for an economy recovering from a financial crisis.

<sup>1</sup> See World Economic Outlook IMF, April 2009

<sup>2</sup> See Schroders Economic and Strategy Viewpoint, 30 June 2009

Of course, the average may not be the best benchmark to judge performance as it includes a range of different economies in terms of size and structure. Nonetheless, the performance of the US is testimony to its flexibility and rapid response to the crisis.

**Reserve currency status has helped the US**

No doubt the better performance by the US also reflects the status of the US dollar (USD) as the world's reserve currency. Unlike most currencies of countries in financial crisis, the USD did not collapse. After initially weakening in 2007 and early 2008, the USD firmed as the crisis deepened with investors seeing the US as a safe haven (chart 2). Despite doubts about the willingness of China and others to maintain close links with the USD, they have continued to fund the US and the currency has held firm. This contrasts with the experience of others in financial crisis who have suffered capital flight and a sharp rise in interest rates, deepening the recession and hampering recovery.

**Chart 2: The USD during the crisis**



Source: Thomson DataStream, 22 April 2010

USD broad exchange index is a measure of the performance of USD against a broad basket of currencies.

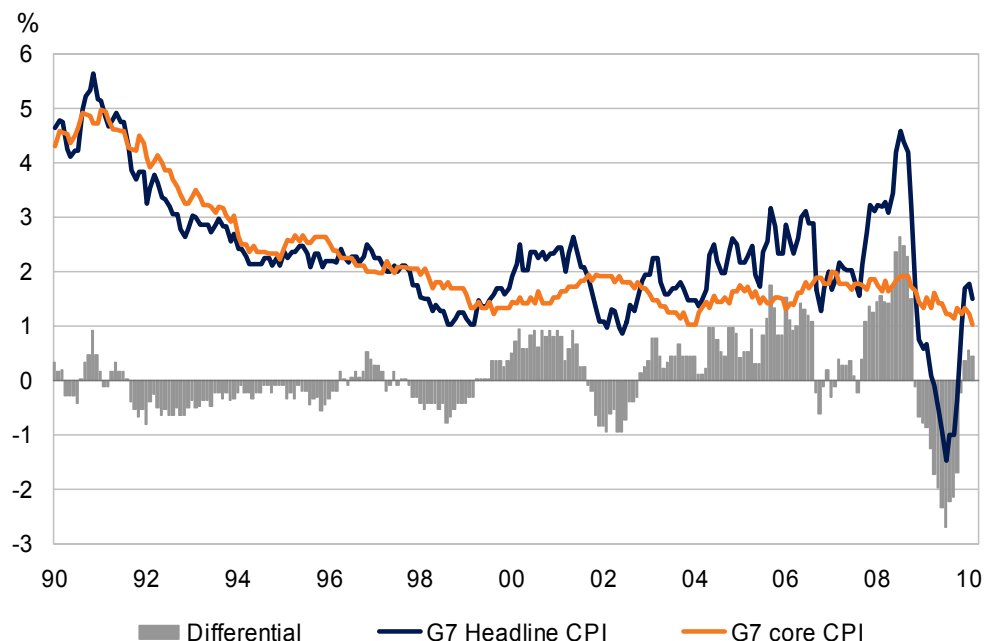
**Significant challenges remain in withdrawing policy support**

Whilst there are good reasons why the US has beaten expectations, we should not be complacent. Policy stimulus has played a big role in the recovery. Monetary policy is likely to stay loose for some time. However, questions are already being asked about the sustainability of government borrowing with the result that fiscal stimulus will be reigned back and reversed in coming years. China is already moving to slow loan growth and has raised reserve requirements. Meanwhile, the private sector in the US, UK and parts of Europe is likely to de-leverage further to restore balance sheets and there has been no pick up in credit growth to support the recovery so far. It could well be that the pessimists are right, but just too early on the timing.

### Into the recovery phase

Despite the better tone to growth, inflation remains well behaved in the advanced economies. There has been a pick-up in headline CPI inflation as a result of the rise in energy prices, but core inflation (CPI ex. food and energy) remains subdued. In the US, core inflation has been broadly flat over the past 5 months bringing the annual rate down to 1.2%, its lowest level since 2003. For the G7, core inflation is at its lowest level for 6 years (chart 3).

**Chart 3: G7 core inflation continues to ebb**



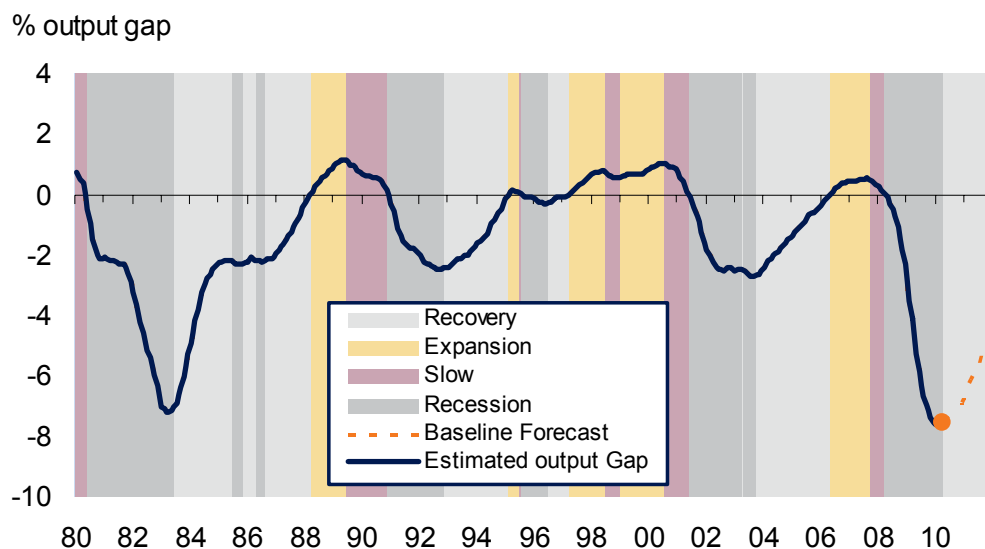
Source: Thomson DataStream, 21 April 2010

### ***Economic 'sweet spot' as we move into the recovery phase***

The combination of rising growth and falling inflation is a characteristic of this stage of the cycle. The presence of a large output gap means that there is little pressure on resources as firms can easily raise output and will look to increase volumes rather than prices. The result is that we experience the "sweet spot" in the cycle as output and profits rise while inflation remains subdued.

In our asset allocation framework we describe this as the recovery phase, which on our definition began in April after nearly two years in recession (see chart 4). The recovery phase tends to be one of the longer phases of the cycle and given that we are starting with a record amount of spare capacity, this time should prove no different.

**Chart 4: Moving from recession to recovery**



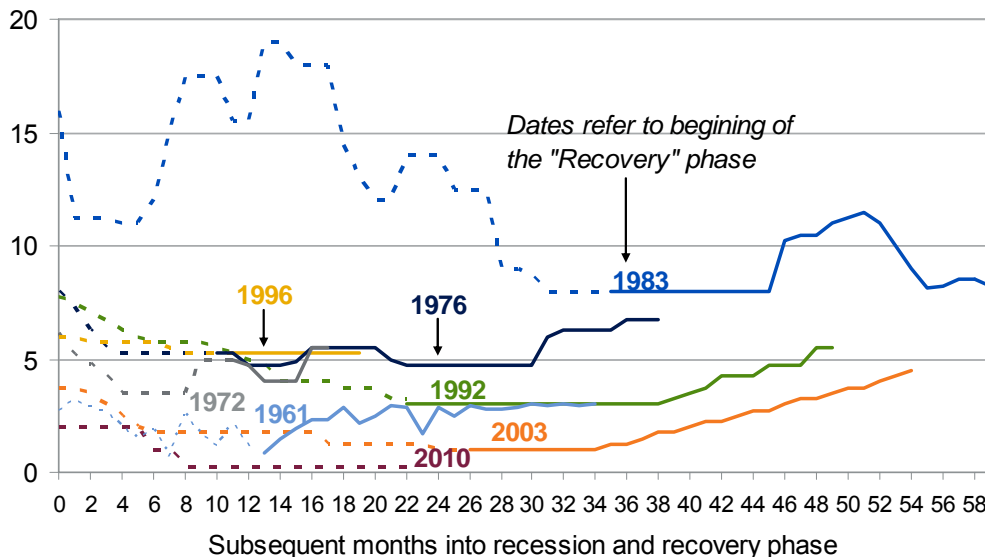
Source: Schroders April 2010

**Recovery will bring higher interest rates**

A key feature of the recovery phase is that monetary policy begins to tighten. As the recovery takes hold and unemployment begins to fall, policymakers look to remove the very loose policy settings put in place during the recession. On average, interest rates rise after 10 months of recovery and thereafter gradually increase. The behaviour of the Fed funds policy target during recent recessions and recovery can be seen in chart 5.

**Chart 5: US policy rates during recession and recovery**

Fed funds target rate at start of recession\*



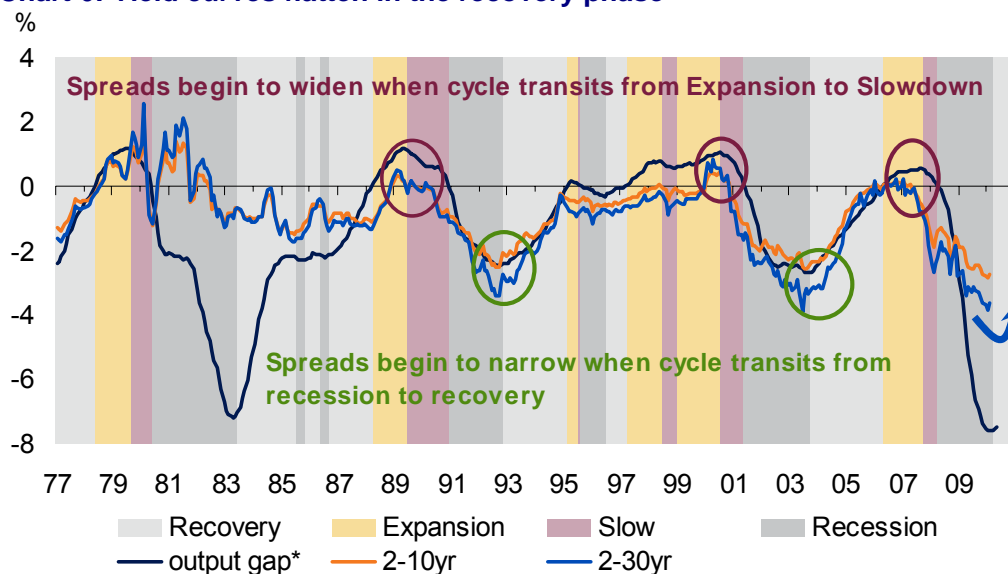
Source: Schroders April 2010

Recession and recovery definition based on Schroders economic cycle. Dotted line refers to the "Recession" phase and solid line refers to "recovery"

### And a flatter yield curve

Rising policy rates result in gradual upward pressure on bond yields and consequently the yield curve can be expected to flatten. At present the gap between 10 and 2 year yields is close to a record wide and we would look for this to narrow as the recovery takes hold (chart 6).

**Chart 6: Yield curves flatten in the recovery phase**



Source: Thomson DataStream, Schroders April 2010

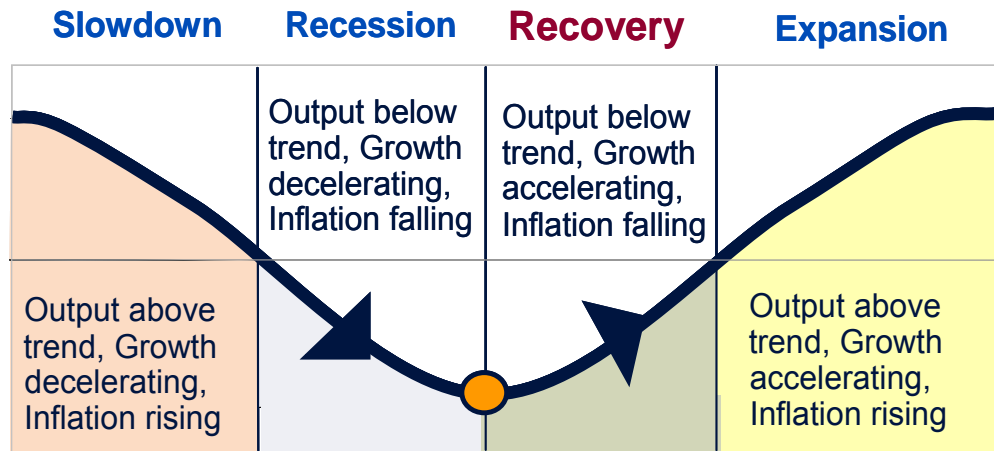
### Move into recovery phase signals shift into real assets

No two cycles are identical and we would be careful to simply extrapolate from one to the next. For example, interest rates could well remain lower for longer in this cycle. Nonetheless, on a cyclical basis the trend is clear and so from an asset allocation perspective, this would suggest moving away from government bonds as yields can be expected to rise. Instead, investors should focus on real assets which benefit from the increase in activity. Our analysis finds that equities and property perform well during this phase.

Rising interest rates are not an obstacle to the performance of risk assets when driven by an improving economy, where growth is improving and inflation is well behaved. It does mean though that equities are unlikely to re-rate and instead their performance tends to be driven by rising earnings.

The main adjustment to asset allocation strategy as a result of the move from recession to recovery is to reduce exposure to government and credit bonds (primarily Investment Grade) which are hit by rising yields, and increase weightings in equity and property (see chart 7).

**Chart 7: Asset Allocation and the economic cycle**  
**Adjusting portfolio exposure for the recovery phase**



**— Output**

**Asset performance ranked by preference and stage of the cycle.**

<i>TIPS</i>	<i>Credit bonds</i>	<i>Equity</i>	<i>Private Equity</i>
<i>Commodity</i>	<i>Hedge Funds</i>	<i>Property</i>	<i>Commodities</i>
<i>Government</i>	<i>Equity</i>	<i>Hedge Funds</i>	<i>Property</i>
<i>Bonds</i>	<i>Government</i>	<i>Private Equity</i>	<i>Hedge Funds</i>
<i>Cash</i>	<i>bond</i>	<i>High yield</i>	<i>EMD</i>
		<i>Infrastructure</i>	<i>Infrastructure</i>
			<i>Equity</i>

Data: S&P 500, GSCI commodity, CSFB hedge fund, US 10 yr Government bonds, UK IPD property, Barclays (ML) credit bonds, US DS Sectors, LPX50 Private equity index., MSCI world Infrastructure index

Source: Schroders, Thomson DataStream

## Eurozone **Crunch time**

What a mess. Ash spewing out of an Icelandic volcano has caused chaos for millions of travellers as the majority of European airports closed for six days. Though this has been a disaster for the aviation industry, markets have been more fixated with the Greek government bond crises.

### **Another crisis, cue the EU bail out**

#### **Volcanic ash closes European airports...**

This month's volcanic eruption in Iceland and the subsequent cloud of ash that moved over Europe lead to six days of paralysis and an estimated cost of \$1.7bn of lost revenues.<sup>3</sup>

According to Giovanni Bisignani, Director General and CEO of the International Aviation Travel Association, at the worst of the crisis chaos had *"...impacted 29% of global aviation and affected 1.2 million passengers a day. The scale of the crisis eclipsed 9/11 when US airspace was closed for three days."*

#### **...but impact on GDP is expected to be small.**

While the aviation sector has taken a significant hit from this event, insurers, travel operators and logistical transport firms have also become the subject of concern. However, from an economic standpoint, the overall impact on the economy will be significantly smaller. For example, the aviation industry in the UK is worth only 0.53% of gross value added. The inactivity of the sector for 6 days is therefore only likely to reduce quarterly GDP growth by 0.035%. The importance of the UK in global aviation means that the relative importance of the sector is greater than the rest of Europe, where gross value added is roughly 0.2. Consequently, the impact on Eurozone growth should be even smaller.

In addition, substitution effects reduce the impact on GDP further. The hotel industry as well as other forms of transport (trains in particular) have benefited from tourists forced to stay longer, and take alternative routes.

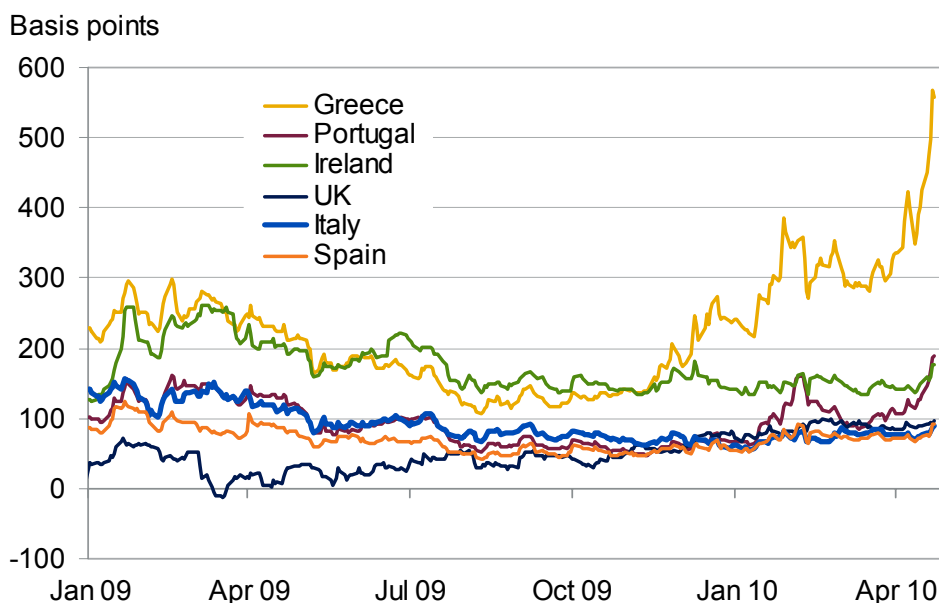
As the volcanic ash cloud dissipates and airplanes take-off again, Europe is back on its way to business as usual. European airlines will bear the biggest brunt of the ash disaster cost, though the European Union has not disappointed in providing its usual response: lots of dithering, then offering aid to the aviation industry. Ring any bells?

### **Here we go again**

Yes, the Greek saga continues to rumble on despite more assurances from Eurozone finance ministers and the IMF that a bail out is forthcoming. Chart 8 illustrates the relentless attack on Greek government bonds from bond vigilantes.

<sup>3</sup> International Air Transport Association (IATA), 21 April 2010.

**Chart 8: 10yr Govt. bond yield spreads over Bunds**



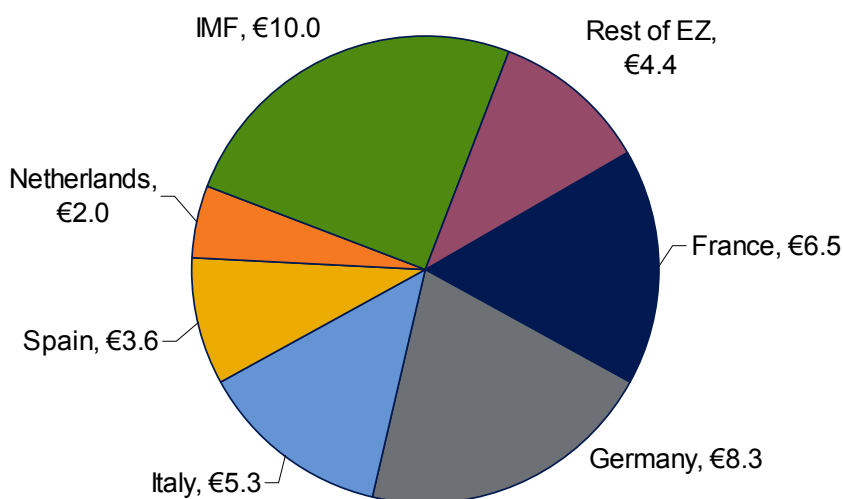
**Bond vigilantes resume attack on Greece despite over €30bn of aid announced**

Source: Thomson DataStream, Schroders, 26 April 2010.

The second to last spike up in the spread between Greek 10-year government bond yields and that of Bunds (chart 8) forced the Eurogroup finance ministers to hold an emergency meeting (on Sunday the 11<sup>th</sup> of April) and rush a statement setting out the size and cost of EU loans to Greece.

The bail out has been designed to last three years coinciding with Greece's plan to reign in its deficit to below 3% of GDP by 2013. €30 billion worth of bi-lateral loans will be provided this year, with the IMF also expected to contribute an additional €10-15 billion. The size of individual country contributions will be in accordance to the size of each country in the Eurozone in GDP terms (see chart 9).

**Chart 9: Expected contributions to Greek bail out**



Source: Schroders, 23 April 2010.

The Eurogroup will charge Greece approximately 5-5.25% for 2-3 year loans. This is considerably cheaper than what the market is offering at the moment – with 2-year Greek Government bonds trading at 13.017%.<sup>4</sup>

Meanwhile, talks between Greek government officials and the IMF finally got underway (delayed due to ash cloud) to negotiate the terms of the IMF Stand by Arrangement. The IMF is likely to demand both budgetary and structural reforms in exchange for the aid, which is likely to cost Greece around 3-3.25% per annum.

### Technical default?

**Markets are worried about a technical default...**

The latest Greek blow-up appears to be driven by fears that the IMF will encourage Greece to 'voluntarily re-structure' its debt obligations (a technical default). European Commissioner for Economic and Monetary Affairs Olli Rehn did not help matters when he said, "*The [Greek] plate needs to be cleaned up from the burden of the past.*"<sup>5</sup> At least the plate is being cleaned and not smashed.

The fear of default is not only visible in the 10-year bond yields, but also by the shape of the Greek yield curve, which has recently inverted (chart 10). This is a classic signal of escalating default fears. Investors demanding a greater premium for lending to Greece in the short-term than in the medium and long-term.

**Chart 10: Greek generic 10-2yr yield curve**



Source: Thomson DataStream, 26 April 2010

**...as well as worse than expected borrowing numbers**

To make matters worse, Eurostat released revised estimates of Eurozone government borrowing that showed the Greek deficit for 2009 was 13.7% of GDP and not 12.7% as previously estimated. This meant that total Greek government debt was also worse than previously estimated: 115.1% of GDP rather than 112.6% for 2009.

<sup>4</sup> Source: Bloomberg. Mid-yield to maturity at close of 26 April 2010.

<sup>5</sup> 22 April 2010.

To complete the hat-trick of bad news for Greece, Moody's downgraded its sovereign debt to A-3. This is the third Moody's downgrade since October 2009, with the agency warning that more downgrades are possible for Greece.

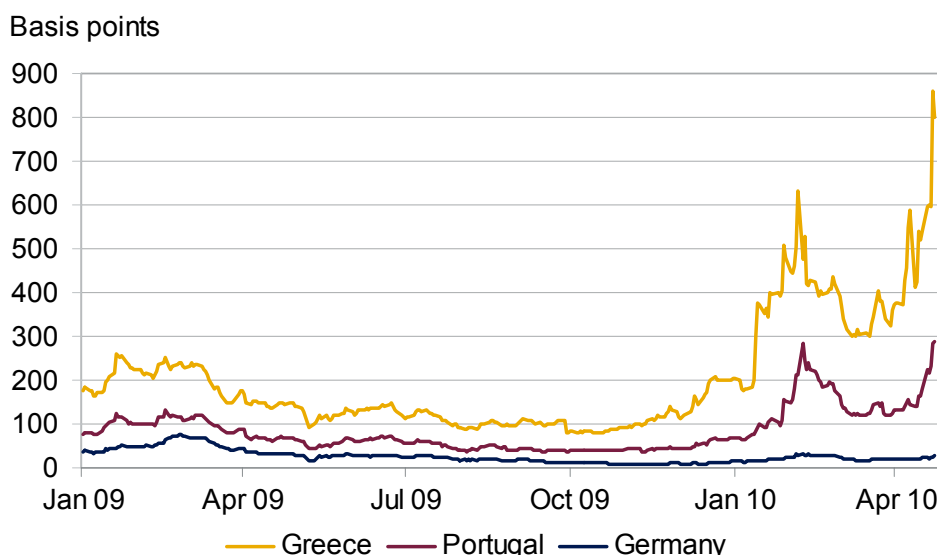
Despite all the bad news and the terrible performance of Greek government bonds, our central view remains that Greece will not move to negotiate a technical default and will receive the loans it has requested in the near future. This is based on our view that Greece will only just about manage to stabilise its debt-GDP ratio over the next three years, and will still need to finance the existing stock of debt. The ultimate fear for Greece is it ends up like Argentina, unable to tap external debt markets for many years.

### European contagion

***Greece is not the only European sovereign facing higher borrowing costs...***

Greece is not the only European sovereign facing higher borrowing costs. As chart 8 showed earlier, Portugal in particular has also seen its bond yields rise versus German Bunds. This is reflected in the credit default swap market – a market which provides insurance against default, in this case, for sovereigns. Chart 11 shows how the cost of insuring against Portugal defaulting has risen as the Greek crisis has escalated.

### Chart 11: 5yr CDS prices



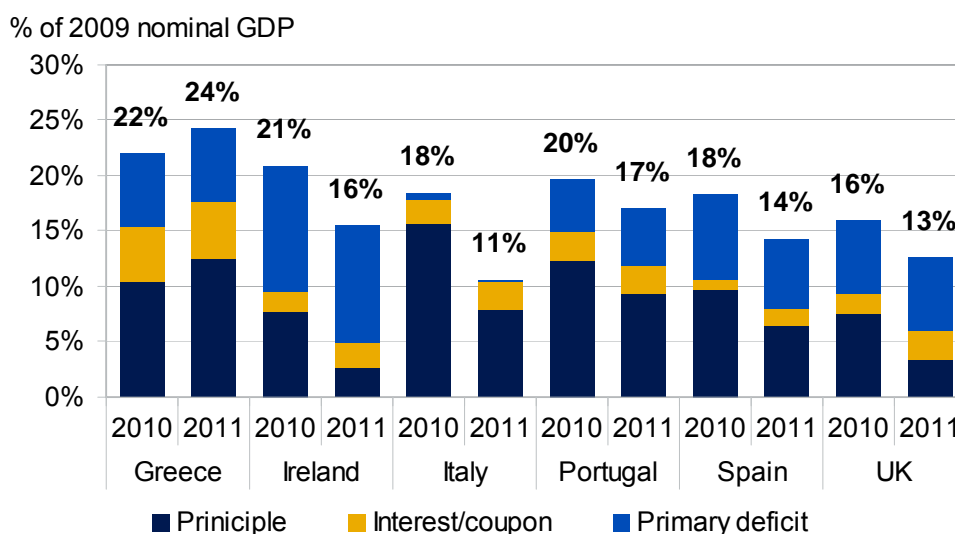
Source: Thomson DataStream, 26 April 2010.

Portugal was criticised this month for its plans to back-load its fiscal consolidation by the European Commission.<sup>6</sup> On the one hand, the European Commission's comments are not helpful as they paint a large figurative target on Portugal for bond vigilantes to aim at. On the other hand, it highlights the independence of the European Commission and works to provide Portugal with the incentives to deal with its deficit before it becomes a Greek-style problem.

<sup>6</sup> European Commission recommendations for Portugal's 2010 Stability Report.

In any case, while we see similarities between Portugal and Greece when we examine the potential debt issuance due in 2010, issuance next year should be falling as the economy begins to recover, and the deficit is reduced (chart 12).

**Chart 12: Potential debt issuance 2010/2011**



Source: Bloomberg, DataStream, ONS, Schroders, European Commission, 21 April 2010.

**...but we don't expect other peripheries to run into the same difficulties as Greece**

As we wrote in February & March<sup>7</sup>, we do not expect Portugal (or Spain, Ireland or Italy) to come under the same pressure as Greece. However, should bond vigilantes turn their attention to Portugal, we would expect a similar bail out to be arranged quickly.

Can the Eurozone afford to bail out Portugal? We estimate that if Portugal was to experience a crisis in the next month, the total cost of a bail out would be about €13 billion for this year – which should be comfortably affordable.<sup>8</sup> We would be more worried if Spain had to be bailed out. The cost of a Spanish bail out presently for this year alone would cost about €55 billion.<sup>9</sup>

There is a further risk that contagion could spread through Greek banks to the rest of the European, and eventually global banking system. At this stage, it is likely that the Greek government bail out will ease the concern over Greek bank solvency. In addition, we expect the European Central Bank to make every possible effort to stop a contagion spreading should the risks materialise.

### Not everyone loses from Greece

**There are some positive effects from the Greece crisis**

Though it may feel like the Greek crisis has brought nothing but misery to Europe, there have been some positive side effects.

The first minor benefit goes to Eurozone members which are enjoying the flight to quality of capital. Despite having to bail out Greece, French and German bonds have performed relatively well since the start of the year. In addition, it appears that the funds which lender countries intend to provide Greece will be financed through the issuance of treasury bills – meaning that Germany and France could earn about 400 basis points per year from their 'support'.

<sup>7</sup> Economic & Strategy Viewpoint (26 February 2010).

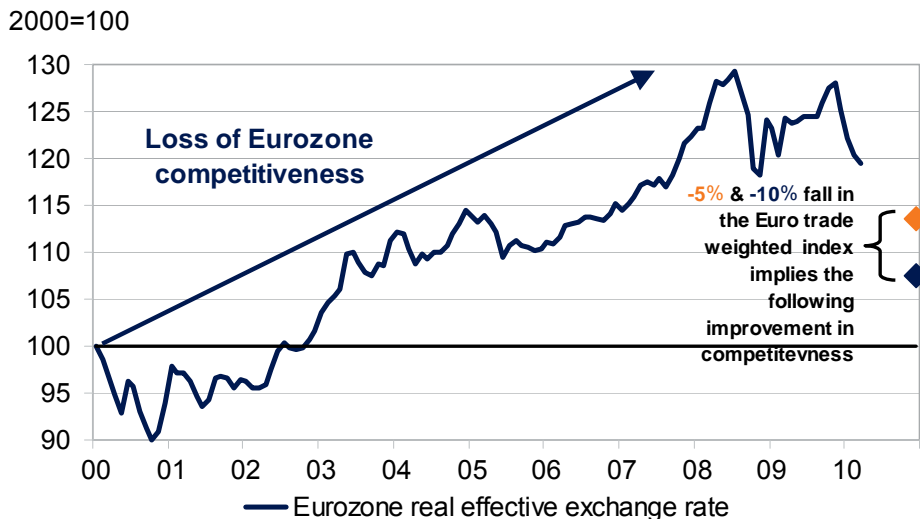
<sup>8</sup> Portugal has raised approximately €11bn this year, and we estimate it needs €24bn for the year in total. 21/04/2010

<sup>9</sup> Spain has raised approximately €58bn this year, and we estimate it needs €113bn for the year in total. 21/04/2010

**A weaker Euro is helping Eurozone exporters regain some competitiveness...**

The most obvious impact has been the recent weakness in the Euro, which has helped reverse the Eurozone's large loss in competitiveness over 2009 (chart 13). Indeed, the Euro could fall a further 5-10% on a trade-weighted basis, which would bring it in-line with the OECD's purchasing-parity fair-value estimates.<sup>10</sup> Assuming a 10% depreciation, Eurozone export competitiveness could rise to levels not experienced since 2003. Though this would cause a marked pick up in inflation through imports, it would also provide a large boost for Eurozone exporters.

**Chart 13: Regaining competitiveness**

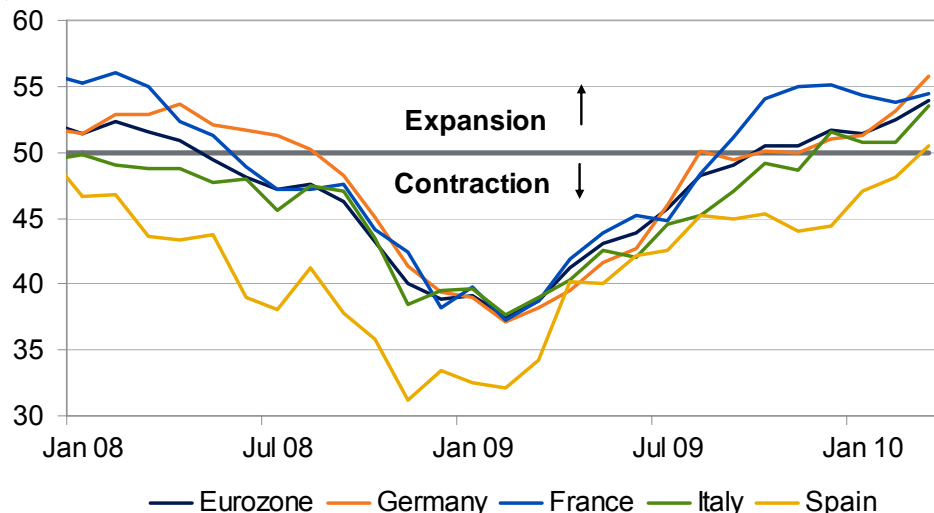


Source: Thomson DataStream, IMF, Bloomberg, Schroders, 23 April 2010.

**...which is feeding through to higher activity...**

Though it is too early to see whether such a large depreciation will actually happen, the recent depreciation is already helping to lift European optimism and activity levels. The latest macro-composite Purchasing Managers Indices (PMIs) as shown in chart 14 have risen in the latest two prints, with even the Spanish PMI returning to positive territory.

**Chart 14: Macro-composite PMIs**



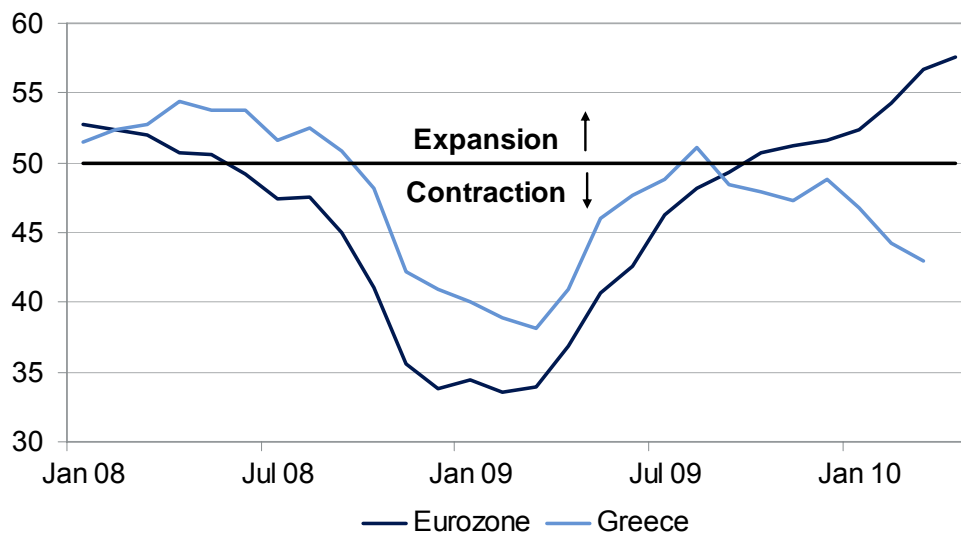
Source: Markit, 22 April 2010.

<sup>10</sup> Based on OECD estimates (7 April 2010).

***...everywhere other than Greece, where tighter fiscal policy is hitting demand and confidence***

However, in the same way that Europe lags behind the rest the world in the global recovery, we expect to see a growing divergence within Europe too between member states that are forced to tighten fiscal policy soon, and those that can afford to wait until the recovery gathers momentum. This is best illustrated by comparing the Eurozone manufacturing PMI with that of Greece in chart 15. Now that implementation of tighter fiscal policy in Greece is underway, businesses are adjusting to expectations of lower GDP growth over the foreseeable future.

**Chart 15: Manufacturing PMIs**



Source: Markit, 22 April 2010.

# UK

## Inflation forecast revised to incorporate 19% VAT

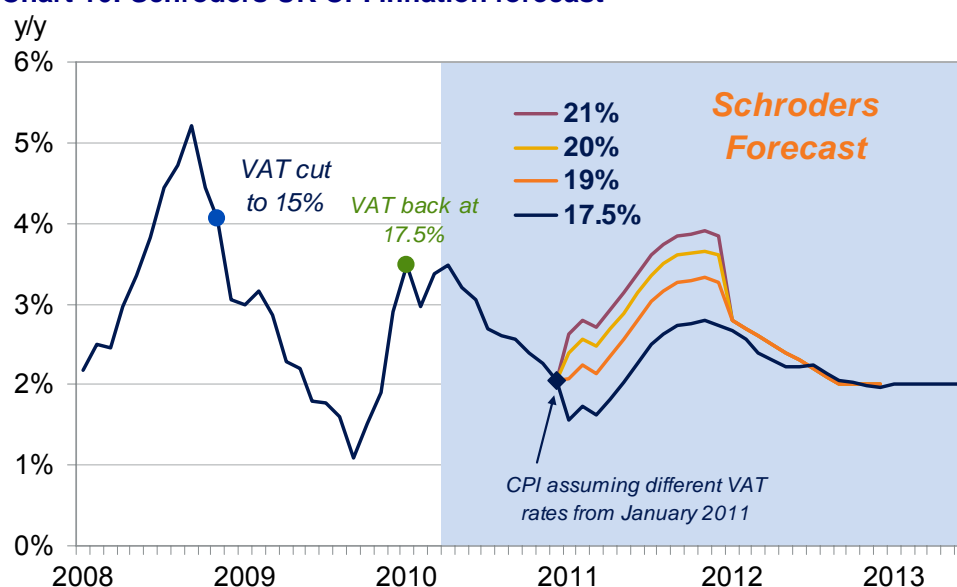
As the UK general election draws closer, the major parties have released their manifestos' outlining their positions on many policies. The most relevant for the UK forecast at present is that neither Labour nor the Conservative party have ruled out an increase in VAT. As we wrote in March, we believe that raising VAT from its current rate of 17.5% to 19% would not only make a significant contribution to the black-hole in the government's budget forecast, but it would also be the most efficient way of collecting revenues quickly. As a result, we are taking the plunge as the first organisation to our knowledge to incorporate explicitly another rise in VAT after the general election.

***We expect VAT to be raised to 19% after the general election***

We assume that the increase will be pre-announced in order to generate a boost in demand (albeit a temporary one), and in order to avoid further distortions in the year on year measure, the increase to be introduced in January 2011 (one year after VAT was re-instated at 17.5%).

Chart 16 shows the Schrodgers previous annual CPI inflation forecast, as well as how the forecast is affected by changing the VAT assumption from January 2011. It also shows the effect of VAT raised even higher, which remains a risk.

**Chart 16: Schrodgers UK CPI inflation forecast**



Source: Thomson DataStream, ONS, Schrodgers, 21 April 2010.

Overall, there is no effect to the 2010 CPI forecast, which we have raised in response to the disappointing March inflation estimate. However, our 2011 CPI forecast is now raised to 2.8% from 2.2% (table 1).

**Table 1: Schrodgers inflation forecast**

	Consumer Price Index (CPI)		Retail Price Index (RPI)	
	New	Previous	New	Previous
<b>2010</b>	2.8%	2.5%	4.0%	4.0%
<b>2011</b>	2.8%	2.2%	3.9%	3.6%

Source: Schrodgers, 23 April 2010.

## Forecast Summary

### I. Forecast summary

Real GDP						
y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus
US	27.3	-2.4	2.8	3.2	2.9	3.1
UK	5.1	-4.9	1.1	1.3	2.5	2.3
Eurozone	25.8	-3.6	1.0	1.2	1.4	1.5
Japan	9.3	-5.2	2.0	2.2	1.6	1.6
Australia	1.9	1.3	2.7	3.3	3.0	3.4
OECD	69.5	-3.3	1.9	2.2	2.1	2.3
China	8.2	8.5	10.0	9.9	9.0	9.0
Emerging*	30.5	0.6	6.0	6.0	5.7	5.7
World	100.0	-2.1	3.1	3.3	3.2	3.3

Inflation CPI						
y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus
US	27.3	-0.3	1.9	2.1	1.0	1.9
UK	5.1	2.2	2.8	2.7	2.8	1.7
Eurozone	25.8	0.3	1.7	1.2	0.7	1.4
Japan	9.3	-1.4	-1.3	-1.1	-0.7	-0.2
Australia	1.9	1.8	2.4	2.6	2.5	2.8
OECD	69.5	0.0	1.5	1.4	0.8	1.5
China	8.2	-0.7	4.5	3.3	4.0	3.4
Emerging*	30.5	4.3	5.8	5.3	5.3	4.9
World	100.0	1.3	2.8	2.6	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-09	Dec-10	Market	Dec-11	Market
US	27.3	0.25	1.00	0.75	2.50	2.14
UK	5.1	0.50	1.00	1.10	2.00	2.49
Eurozone	25.8	1.00	1.00	1.03	1.75	1.80
Japan	9.3	0.10	0.10	0.36	0.25	0.45
OECD	67.5	0.53	0.88	0.83	1.87	1.80

Market data as at

22/04/2010

#### Key variables

FX	Current	Dec-09	Dec-10	y/y%	Dec-11	y/y%
USD/ GBP	1.54	1.62	1.50	-7.5	1.55	3.3
USD/ EUR	1.33	1.46	1.30	-10.8	1.35	3.8
JPY/ USD	93.4	90.0	95.0	5.5	97.5	2.6
GBP/ EUR	0.87	0.90	0.87	-3.6	0.87	0.5
Brent crude	84.8	74.9	79.1	5.6	80.3	1.6
US output gap %GDP	-7.4	-8.0	-6.3		-3.9	
Unemploy. %	9.7	10.0	9.2		8.0	

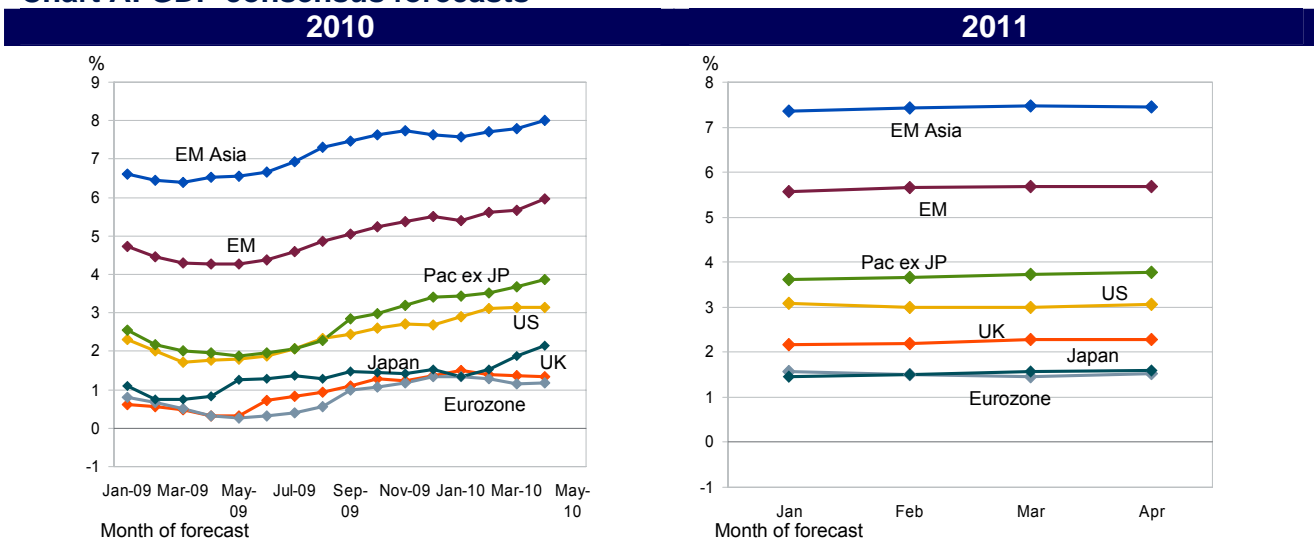
Source: Schroders, Datastream, IMF, Consensus Economics (Apr. 10)

- Our forecast for global growth have been raised by 0.4% since the last CMF with the world economy now expected to grow by 3.1% this year. For 2011, we expect global growth of 3.2%, unchanged from last December. The upgrade has been driven by the US and emerging markets, with little change in the European forecasts.
- After the recession of 2008 and 2009H1, the recovery has been driven by the industrial sector and stronger government spending. The main impact was in 2009Q4 and should last until 2010Q1. 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 and 2011. 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 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. Rates are forecast to rise in the UK in November and January next year in the Eurozone.

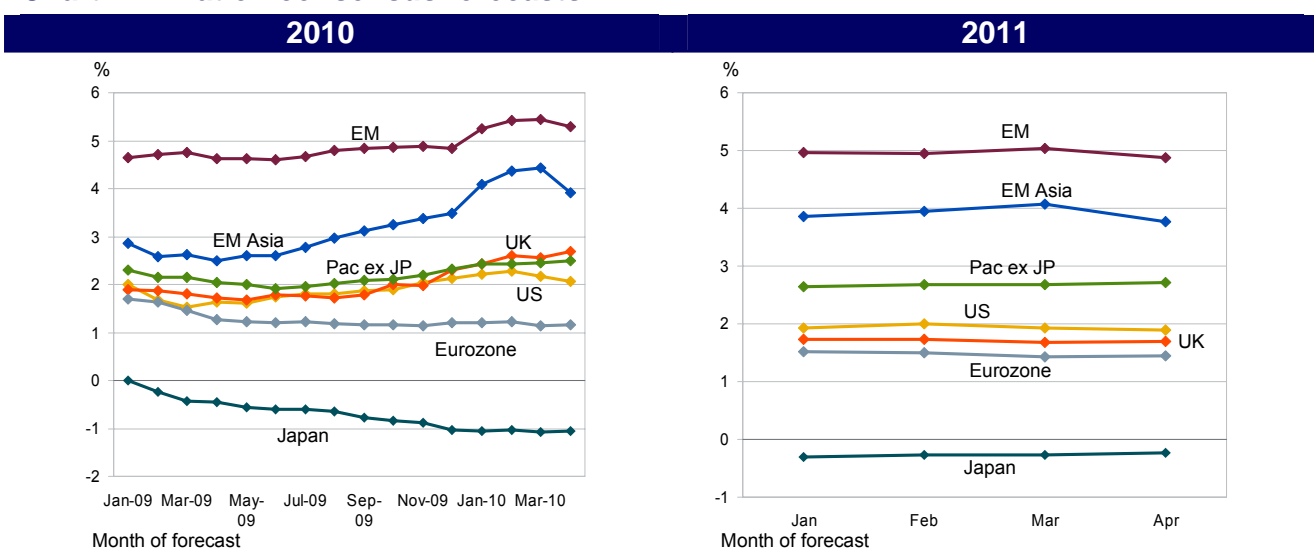
## II. Updated forecast charts - Consensus Economics

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 (April 2010), 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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