23 August 2010

For professional investors only

Schroders

Economic and Strategy Viewpoint

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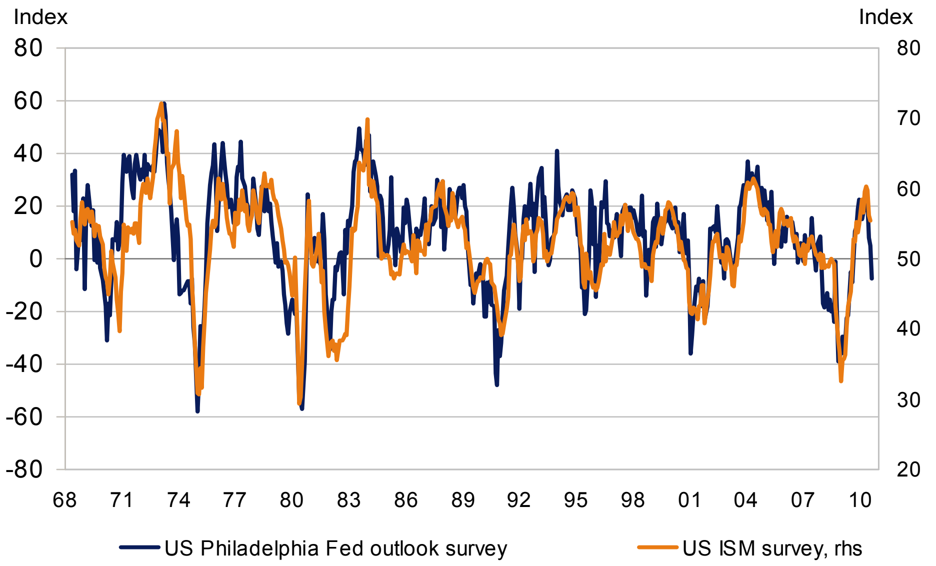
Global: Has the US economy stalled?

- **The latest figures suggest that the US economy lost momentum around mid year and the Federal Reserve has downgraded its assessment of the outlook. With the economy now growing at close to stall speed it would not take much in the way of a shock to tip it into a double dip. Some indicators suggest we may be already there (see chart).**
- **It remains our view that the economy will avoid going back into recession as we believe that the private sector has retrenched sufficiently to be in a position to begin spending again. Our analysis of the second quarter GDP data also suggests that economy may be stronger than recognised given the surge in imports during the span.**
- **Nonetheless, the experience of previous recoveries suggests that when GDP growth falls below 2½% the Fed reacts by cutting interest rates. Today that option is not available and consequently we would expect the US central bank to start another round of quantitative easing in the near future.**

Europe: Growth resumes, but for how long?

- **Growth is back across Europe, with Germany, Austria, the Netherlands and the UK significantly outperforming expectations. The stronger than expected data has to be looked at in context with the terrible start to the year, but the outlook overall remains positive.**
- **However, with activity in export markets slowing, can Europe rely on domestic demand to maintain its recent growth? If so, then German consumers must remember what it's like to spend spend spend.**
- **Meanwhile, the sovereign debt and banking crisis have not been resolved and with external demand floundering, we expect monetary policy to remain very loose for longer.**

US ISM and Philadelphia Fed survey ("Philly Fed")



Source: Thomson Datastream, 23 August 2010

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Global

Has the US economy stalled?

Rate expectations fall as double dip concerns increase

Fears of a double dip remain high with the Federal Reserve downgrading its assessment of the US economy this month. Interest rate expectations have fallen again with US Treasury yields falling sharply (chart 1) and the curve experiencing a bull flattening (chart 2).

Chart 1: US government bond yields

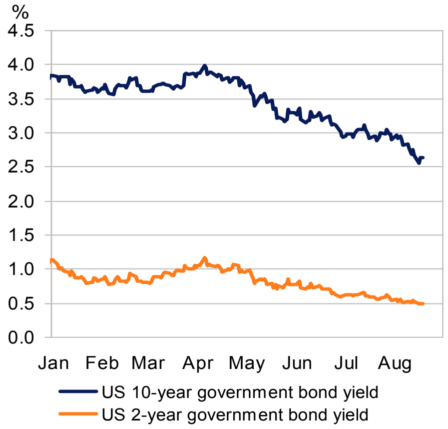


Chart 2: US yield curve flattens

Source: Thomson Datastream, 19 August 2010

Lower rates and flatter curves are normally associated with weaker growth, but equity markets continue to ignore the message from the bond market. Instead, risk assets have rallied over the past month with equities, credit and commodities performing strongly. Furthermore, performance within these asset classes has been led by the more cyclical industrial and material sectors with emerging markets leading the regions. The stand-off between equity and bond investors continues.

Our macro view of no double dip suggests that equity investors will eventually win this debate, but the Fed's assessment and a run of disappointing figures (including another weak payroll) mean that the pendulum has swung in favour of the "double dippers" once more this month.

We gave our reasons for not expecting a double dip in last month's *Viewpoint*[1] where essentially we see the economy being supported by increased corporate spending. Strong profits growth and healthy cash flows indicate that firms will raise capex and employment in coming months. Meanwhile, although still fragile, the household sector has already been through a considerable retrenchment, raising its savings ratio to the highest level for more than a decade in both the US and UK.

Economy hit soft patch around mid-year

US economy lost momentum around mid-year

More recently, the gloom has been increased by the news that the US economy was even weaker than previously expected in Q2. Economists now expect growth during Q2 to be revised down to 1½% annualised from an original estimate 2.4%. Although this may sound like ancient history, it adds to the perception that the US economy has stalled and is vulnerable to the slightest shock which might reduce demand. So far, the third quarter is not looking any better and with growth at such a minimal level it would not take much to tip us into the double dip.

[1] See: Heading for a double dip? Economic and Strategy Viewpoint July 22nd 2010

Import surge at odds with weak economy

Trade is responsible for much of the US slowdown, a consequence of an import surge

To stay with the GDP figures, we believe that many are taking an unduly pessimistic view of the underlying strength of the US economy. The slowdown between Q1 and Q2 is partly due to a smaller contribution from inventory which took 1.5 percentage points off growth. However, the real swing factor was trade which dragged by 2.5 percentage points (table 1). Revisions will make this even more negative as the trade figures have turned out worse than expected with the deficit just shy of $50bn in June.

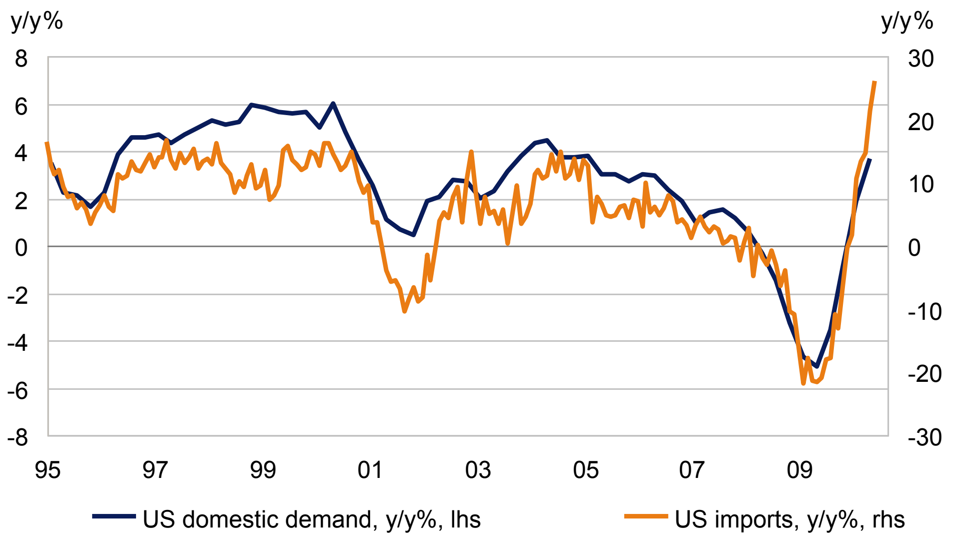
Table 1. Accounting for slower growth - US GDP breakdown

Qtr-Qtr annualised %	2010q1	2010q2	Difference
Real GDP	3.7	2.4	-1.3
Final sales	1.1	1.3	0.2
Domestic final sales	1.3	4.1	2.8
Net exports (contrib.% pts)	-0.3	-2.8	-2.5
Inventories (contrib.% pts)	2.6	1.1	-1.5

Source: Bureau of Economic Analysis, Schroders, 24 August 2010

The deterioration in the trade contribution reflects a massive surge in imports, up nearly 30% annualised in Q2, whilst exports rose 10%. Imports are driven by domestic demand and although domestic final sales rose 4%, the increase in imports was remarkably strong (chart 3). It is possible that the trade numbers are overstated, but they tie in with anecdotal evidence from companies such as Maersk, owner of Maersk Line, the world's largest container carrier and Dubai's DP world which report significant growth in traffic this year, particularly between North America and Asia.

Chart 3: US domestic demand and imports



Source: Thomson Datastream, Schroders, 20 August 2010

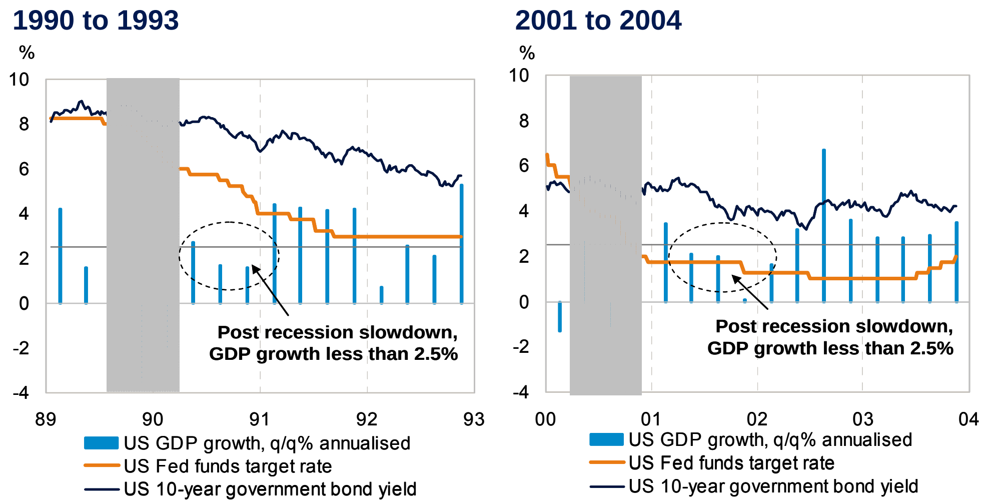
One explanation for the import surge would be that the US economy had lost competitiveness, thus making it easier for overseas producers to gain market share, but this seems unlikely given the performance of the US dollar. This suggests that the underlying economy was performing more strongly than expected with either the gain in domestic demand understated, or that the rise in imports heralds stronger spending to come. Either way this suggests that US activity is on a firmer footing than the headline numbers would suggest.

Looking back

Growth has slowed sharply before, prompting the Fed to ease

Periods where a recovery has appeared to stall are not uncommon. Looking at the last two US recoveries, in the early 1990's and 2000's, both saw GDP growth drop below 2½% annualised after the recession had ended. Both were periods where the outlook was seen as "uncertain" by the Fed. In each case the Fed eased, bond yields fell and the economy bounced back (see chart 4).

Chart 4: Comparison of growth and interest rates during past US recoveries



Source: Thomson Datastream, Schroders, 20 August 2010

This illustrates how even a normal recovery can be vulnerable to bouts of weakness once the inventory cycle has run its course. The current recovery is all the more likely to suffer given the de-leveraging headwinds on activity. It also highlights a key difference with today: monetary policy was effective in supporting the recovery in the early 1990's and 2000's whereas today there are doubts about its potency given the de-leveraging of balance sheets.

This suggests more QE is ahead

That does not mean that the Fed will not try to do something. Although we do not expect an outright double dip, growth could well be slow enough to prompt a reaction and we would not rule out further Quantitative Easing (QE) in the US in coming months. We do not believe that it would have much effect on the economy, but the Fed will want to be seen to be responding. The impact on the financial markets could be quite powerful, however.

In addition to QE, we would also watch for the announcement of further stimulus from the administration ahead of the mid-term elections in November.

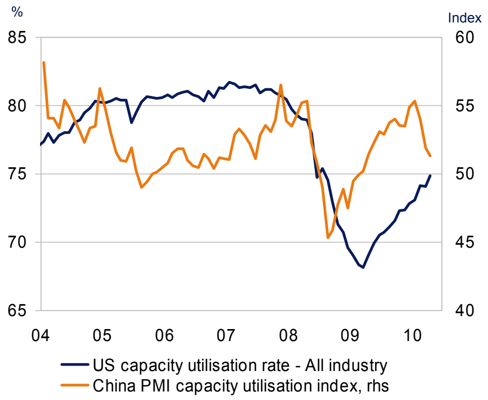
China cooling

Inflation coming under control in China

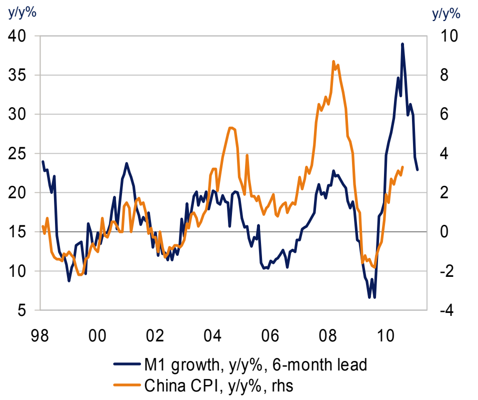
Whilst the US is struggling to find growth, China has been struggling to lose it. Earlier in the year we were concerned that the surge in money growth combined with the level of capacity use meant a pick up in inflation. That has now transpired and may have further to run given the surge in wheat prices. However, our two inflation indicators for China have cooled significantly in recent months as growth has slowed and the authorities have successfully clamped down on bank lending. This suggests that inflation will come under control once the burst in food price inflation has passed (see chart 5). It may be too early for the Chinese authorities to take their foot completely off the brake, but the period of tightening may well be behind us.

Chart 5: China inflation indicators head lower

Capacity utilisation in the US and China



M1 growth slows sharply in China



Source: Thomson DataStream, 21 April 2010

Looking ahead

Next month we will review our forecasts for global growth and inflation. At this stage it is likely that we will have to trim our US GDP forecasts to reflect the weaker performance of the economy around mid-year. However, forecasts for Europe are likely to be less affected given the recent improvement in indicators (see below). Interest rate rises are likely to be delayed until late 2011.

Europe

Europe: Growth resumes, but for how long?

Despite the debt crisis in southern Europe over the first half of the year and the subsequent doom and gloom in financial markets, the European real economy performed surprisingly well. Germany has led the way experiencing its fastest rate of quarterly GDP growth since re-unification, while even Spain has managed to continue growing in spite of unemployment reaching 20%, and fiscal consolidation taking priority.

The role of Germany as a leader has never been more important both politically and economically. However, as the US economy threatens to grind to a halt, taking China with it, can Europe stand alone, or will it be toppled like the final domino in the double-dip procession?

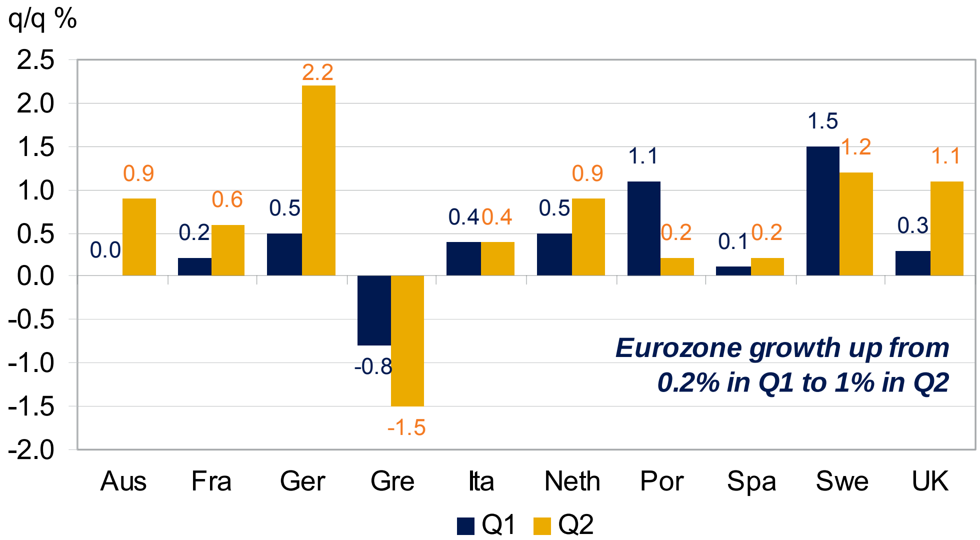
Half-time outlook more positive

Strong second quarter data salvages first half…

After the terrible first quarter GDP numbers, many had written off the Eurozone's recovery and begun to focus more on the sovereign debt crisis, and the possibility of the break-up of the monetary union. More than halfway through the year and the outlook is rosier. Second quarter growth data confirmed that adverse weather had a dramatic impact on northern Europe in the first quarter, particularly on activity in the manufacturing and construction sectors. However, as the weather improved, so did growth, with Germany grabbing the headlines as it grew at its fastest rate since re-unification. Though these are preliminary estimates, it appears that external demand played an important role in the second quarter. More export orientated/dependent economies like Germany, the Netherlands and Austria considerably outperformed the economies with severe external imbalances, like Portugal, Spain and Greece (chart 7).

As Germany growth rockets to fastest rate since re-unification…

Chart 7: First half GDP growth



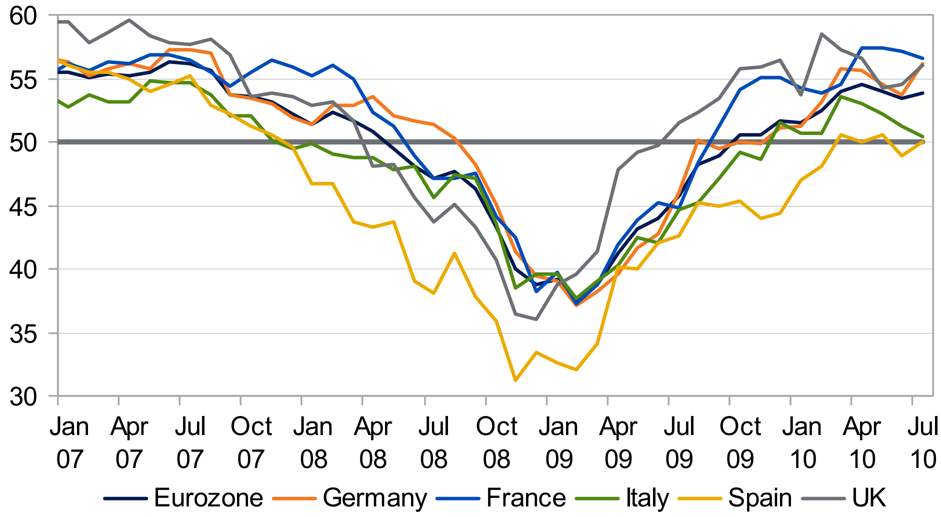
Source: DataStream, Eurostat, ONS. Updated 23 August 2010.

The second quarter numbers are flattered by the poor performance of the first quarter, but taking the first half of the year as a whole, most economists (including ourselves) will be revising up 2010 forecasts.

…however, we expect growth to slow in the second half of the year

As we progress through the second half of the year, many expect European growth to moderate, but questions remain over the sustainability of the recovery, particularly as the US and China have begun to slowdown. So far, leading European indicators have remained robust. The macro composite indicators from the purchasing managers' indices (PMIs) continue to indicate a steady recovery (chart 8).

Chart 8: Purchasing managers indices (PMIs) – Macro composite*

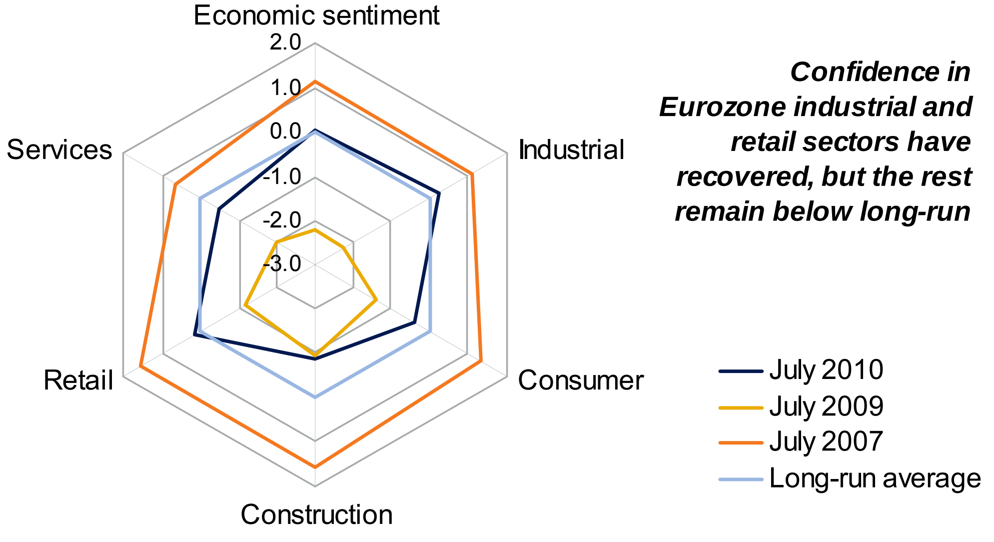


Source: Markit. Updated 20/08/2010.
*Macro composite produced by Markit by creating a weighted average of Manufacturing and Services PMIs, using GDP sectoral weights. UK composite includes CBI retail sales.

Taking a closer look at the individual sectors, we find that confidence levels remain relatively low. Chart 9 shows the latest reading from the European Commission's sentiment surveys, comparing July's data with the same period in 2009 and 2007, relative to long-term averages. The current results show a considerable improvement from last year, though with the exception of the retail and the industrial sectors, confidence remains below long-term average levels. The contrast between the consumer and retail surveys is interesting. The weaker reading from the consumer survey suggests households remain cautions with their finances. However, the stronger retail reading suggests retail businesses are seeing better trading conditions.

Confidence remains low relative to 2007 highs

Chart 9: Eurozone confidence indicators by sector



Confidence in Eurozone industrial and retail sectors have recovered, but the rest remain below long-run

Source: DataStream, European Commission. Readings normalised to show standard deviations from long-term average. Updated 23 August 2010.

The construction sector is unlikely to return to long-run averages in the near future, especially after the structural damage done in southern Europe (and the Baltics) following over-exuberance in residential property markets.

Euro weakness will help eventually

Euro weakness presents upside risks to growth forecasts…

In the June edition of the Economic & Strategy viewpoint, we highlighted the upside risk to our growth forecast following the sharp depreciation of the Euro on a trade weighted basis. The Euro is currently down approximately 13% from its peak on the 23rd of October 2009, which is helping Eurozone exporters win a larger share of global demand (chart 10).

Chart 10: Euro nominal trade weighted index

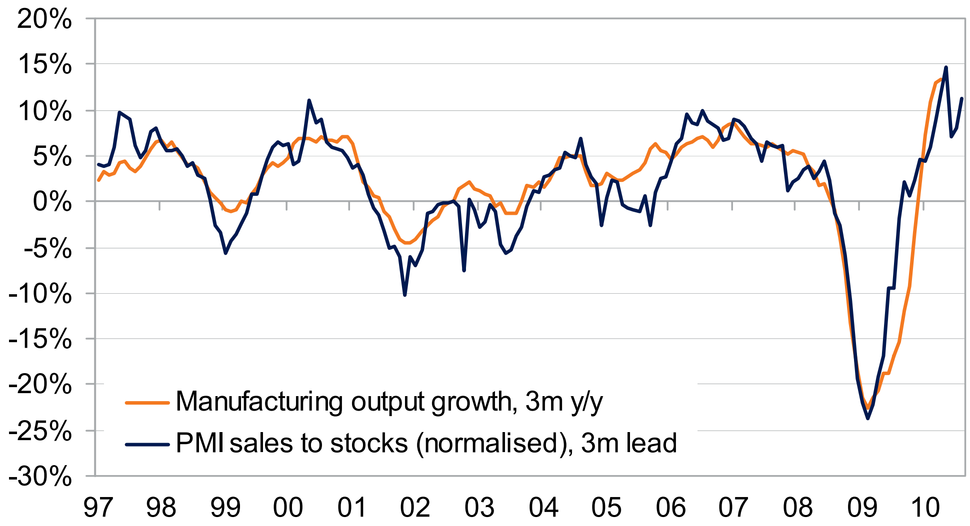
Source: DataStream, Bank of England. Updated 23/08/10.

…though the impact will take time to take affect

However as we have previously mentioned, the expected boost from the Euro's depreciation is likely to take affect with a lag. Also, we highlighted that the boost to growth is dependent on all other factors remaining equal, and the economy being in equilibrium (neutral output-gap). Therefore, if the US and China, which make up 41% of the extra-Eurozone exports, experience a slowdown, part of the boost from the Euro's depreciation will be offset.[2]

Indeed, looking at the German PMI sales to stock ratio indicator, it suggests that German manufacturing output should contract by 1% over the third quarter, albeit following very strong growth of 5.3% in the second quarter (chart 11).

Chart 11: German manufacturing output vs. PMI sales to stocks ratio



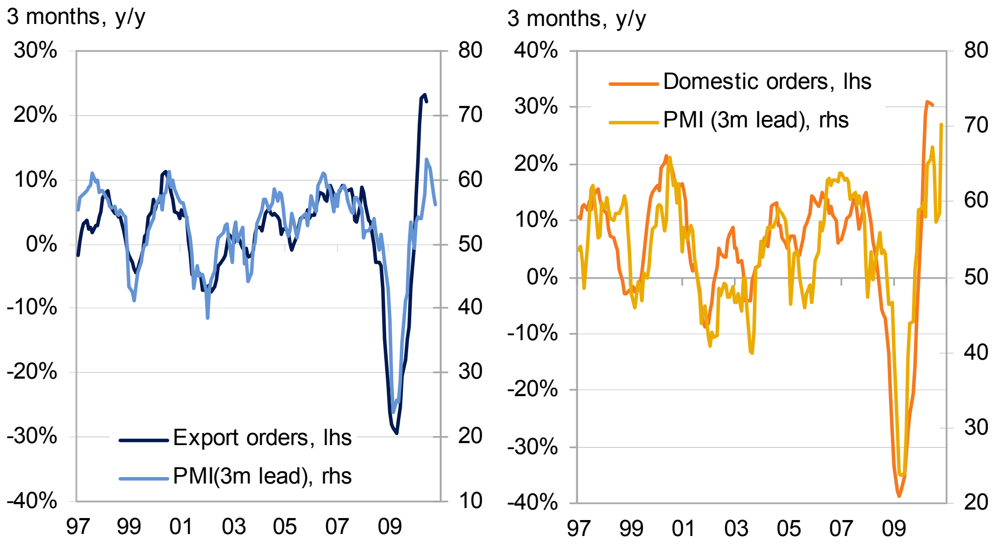
Source: DataStream, Markit. Updated 20/08/10.

Leading German indicators suggest overseas orders are slowing down…

PMI survey evidence suggests that the slowdown in activity in the rest of the world is already beginning to temper demand for German exports, and that recorded export orders may fall sharply in the coming months (chart 12). However at the same time, the leading PMI indicator for domestic manufacturing orders suggests that domestic orders are holding up well, and may continue to run at a 3-month annual growth rate in excess of 25% (see chart 13 on next page).

[2] Based on exports to the US plus China and Hong Kong (as much of Hong Kong trade data is recorded in Hong Kong, but is actually Chinese) using 2009 nominal data from the IMF Direction of Trade Statistics (DOTS).

Charts 12 & 13: German manufacturing new export & domestic orders vs. PMI indicators



Source: DataStream, Markit. Updated 23/08/10.

Although German domestic demand seems to be holding up

The continued strength in domestic demand for manufactured goods is encouraging. Though we cannot apply this story to the whole of the Eurozone, Germany is somewhat of a sleeping giant, and any sign that its businesses and consumers may be ready to spend is a positive signal for the rest of the union.

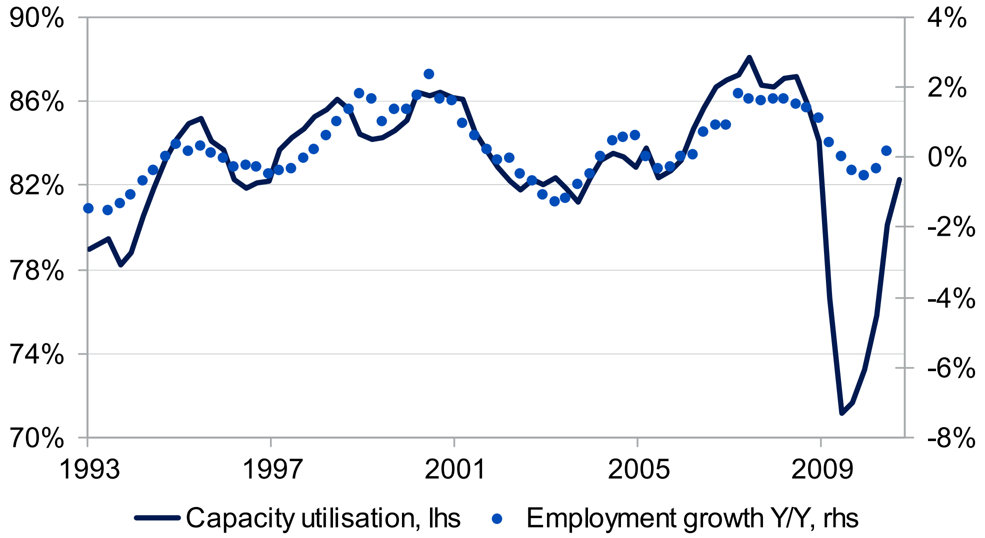
Awakening the sleeping giant

Since the formation of the monetary union, Germany has had to endure higher interest rates set by the European Central Bank than would otherwise have been set by the Bundesbank. This was required if southern Europe and Ireland was to be kept in check, but the higher rates meant that German workers experienced significant wage deflation relative to its competitors.

Today we find a competitive German workforce specialised in high-tech capital goods, enjoying a weaker currency and ultra-loose monetary policy. Despite this, German households continue to remain cautious with their spending, fearful that the part-time working subsidies are working like an anaesthetic for a very poorly patient. To a certain extent, that is exactly what the part-time working government subsidies have done, except that the patient is now recovering.

Unexpectedly strong growth is helping to remove the excess spare capacity in the German economy, which means there will be less pressure on firms to shed jobs over the second half of the year. As chart 14 shows, capacity utilisation is close to neutral levels, and will soon be supportive of employment growth

Chart 14: Germany – slack being removed



Source: DataStream. Updated 23/08/10.

Could the German consumer drive European and world growth?

Though we expect growth to ease over the second half of the year, a significant pick up in employment growth in Germany could spur consumer confidence, and with negative real interest rates, and robust household balance sheets, perhaps German consumers could re-awaken, and perhaps, become a new driver of European and world growth.

Downside risks to keep monetary policy ultra-loose

Taking a step back from Germany, the economic recovery in Europe still has to overcome a number of obstacles. Markets have been distracted by the prospects of a US double-dip recession, rather than the European sovereign debt crisis, and the European banking crisis. More details are slowly emerging of the €750bn stabilisation facility, while Greece is about to successfully pass its first joint IMF, European Commission & European Central Bank quarterly review of its implementation of fiscal and structural reforms. The European Commission is expected to give the green light for the second tranche of funding to be released in September.

Meanwhile, the European banking stress test helped calm market fears over major bank holdings of bad European debt, not by releasing the test results themselves, which were widely viewed as being too soft, but the publication of detailed information on the holdings of major European banks. This helped experts make up their own mind, and confirmed that most European banks are in a better state that feared.

However, Europe's problems have not been resolved. The banking system remains vulnerable and requires substantial additional recapitalisation. In addition, southern European governments not only need to finance new borrowing, but they will need to return to the market next year to re-finance debt that is set to mature. This is likely to refocus the market's attention on southern Europe at some stage.

The Sovereign debt crisis, slowing external demand and fiscal tightening means monetary policy has to remain ultra-loose for longer

Fiscal tightening is already underway across southern Europe, but it is set to accelerate in 2011 with Germany keen to set a good example to the rest of the union.

As a result, we expect the ECB to keep interest rates on hold for at least another 12-months, and as Axel Weber (President of the Bundesbank) hinted recently, extend the 3-month, monthly and weekly unlimited liquidity auctions into next year (there is only one more 3-month auction currently due to take place in September).

As for the Bank of England, the presentation of the August Inflation Report has led us to question our assumptions about the Monetary Policy Committee's (MPC) reaction function. Though inflation is now expected to remain above target for the next two years, the majority of the MPC believe that the risks to inflation over the medium term is to the downside, pointing to high unemployment, weakening external outlook, and fiscal tightening. Therefore, we have pushed out our first UK rate rise to August 2011, and only expect interest rates to reach 1.25% by the end of the year.

We have yet to update our growth and inflation forecasts, but these are likely to rise for both the UK and Eurozone on the back of recent stronger data, and loose monetary policy for longer.

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Forecast Summary

I. Forecast summary

Real GDP

y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus
US	27.3	**-2.6**	**3.3**	2.9	**2.7**	2.8
UK	5.1	**-4.9**	**1.3**	1.5	**2.3**	2.0
Eurozone	25.8	**-4.1**	**1.2**	1.2	**1.5**	1.4
Japan	9.3	**-5.2**	**2.5**	3.2	**1.6**	1.5
Australia	1.9	**0.9**	**3.6**	3.0	**3.2**	3.4
OECD	69.5	**-3.6**	**2.3**	**2.2**	**2.1**	**2.1**
China	8.2	**8.6**	**10.5**	9.9	**9.0**	9.0
Emerging*	30.5	**1.1**	**6.7**	6.4	**5.7**	5.7
World	100.0	**-2.2**	**3.6**	**3.5**	**3.2**	**3.2**

Inflation CPI

y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus
US	27.3	**-0.3**	**1.5**	1.6	**0.9**	1.4
UK	5.1	**2.2**	**2.8**	3.0	**2.8**	2.6
Eurozone	25.8	**0.3**	**1.7**	1.5	**1.0**	1.6
Japan	9.3	**-1.1**	**-1.0**	-1.0	**-0.3**	-0.2
Australia	1.9	**1.8**	**2.6**	3.0	**3.0**	3.0
OECD	69.5	**0.0**	**1.4**	**1.3**	**1.0**	**1.4**
China	8.2	**-0.7**	**4.5**	2.9	**3.8**	3.0
Emerging*	30.5	**4.3**	**5.8**	5.1	**5.3**	4.8
World	100.0	**1.4**	**2.7**	**2.5**	**2.3**	**2.4**

* **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, Romania, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

Interest rates

%	Wt (%)	Dec-09	Dec-10	Market	Dec-11	Market
US	27.3	0.25	0.25	0.37	1.25	0.86
UK	5.1	0.50	0.50	0.76	1.25	1.19
Eurozone	25.8	1.00	1.00	0.90	1.50	1.18
Japan	9.3	0.10	0.10	0.30	0.25	0.25
OECD	67.5	**0.53**	**0.53**	0.59	**1.21**	0.92
Market data as at			23/08/2010			

Key variables

FX	*Current*	Dec-09	Dec-10	y/y%	Dec-11	y/y%
USD/ GBP	*1.55*	1.62	1.40	-13.7	1.45	3.6
USD/ EUR	*1.27*	1.46	1.20	-17.7	1.18	-1.7
JPY/ USD	*85.1*	90.0	95.0	5.5	97.5	2.6
GBP/ EUR	*0.82*	0.90	0.86	-4.6	0.81	-5.1
Brent crude	*73.0*	74.9	78.1	4.4	79.5	1.8
US output gap %GDP	*-7.0*	-8.0	-5.9		-3.5	
Unemploy. %	*9.7*	10.0	9.3		8.1	

Source: Schroders, Datastream, IMF, Consensus Economics (August 10)
Real GDP, inflation CPI and key variables (June 2010), interest rates (August 2010)

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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

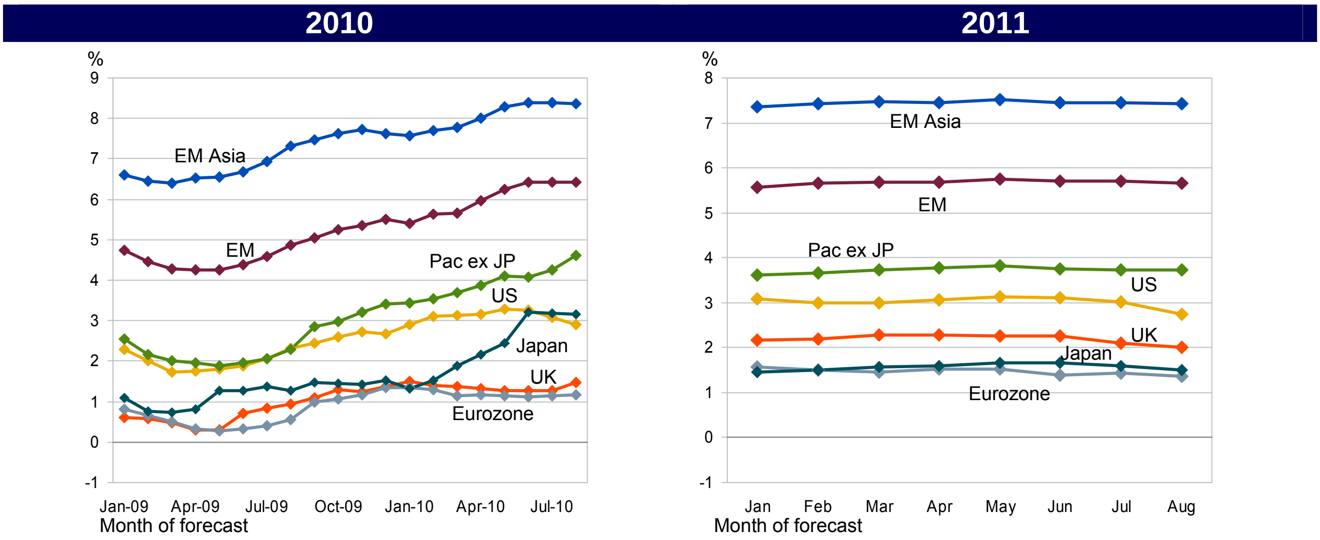
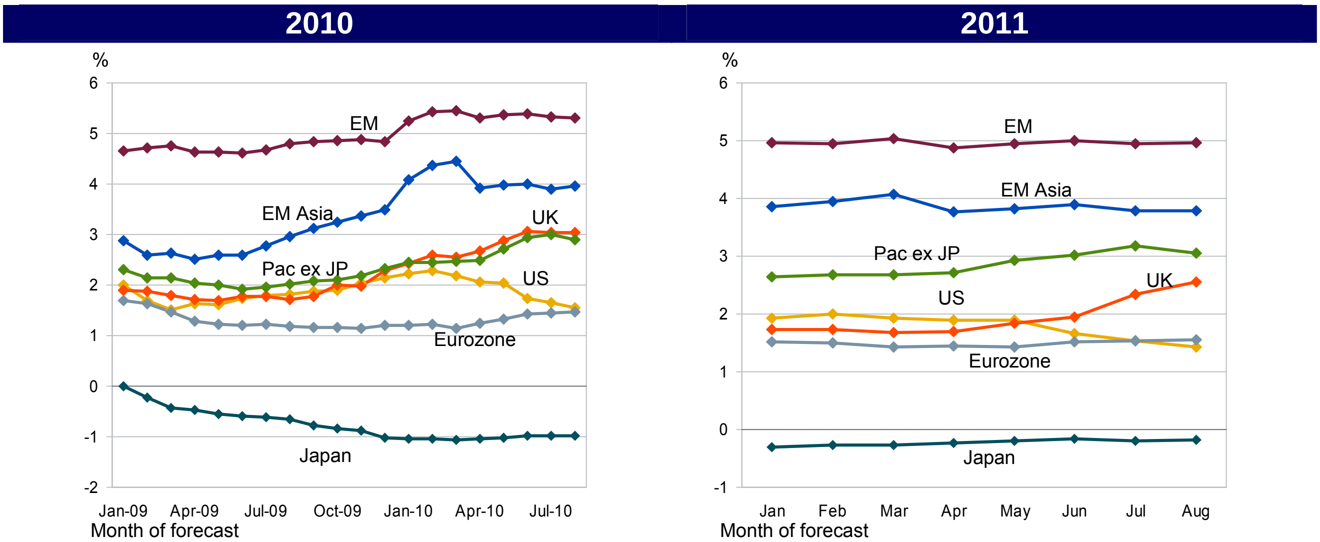


Chart B: Inflation consensus forecasts



Source: Consensus Economics (August 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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