

# Schroders

## Economic and Strategy Viewpoint

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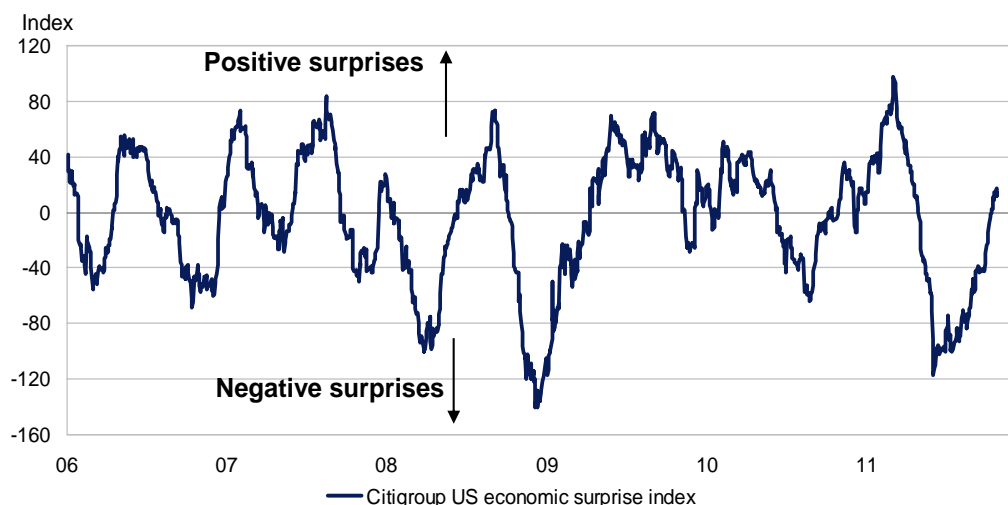
### Global: Back from the brink

- Having stared into the abyss earlier in the year, there are signs that the US economy is lifting after stalling in the summer. Data has started to surprise on the upside with employment, the manufacturing purchasing managers index (PMI), retail sales and durable goods orders beating expectations. China also appears to be avoiding a hard landing with the recent GDP report and PMI's pointing toward a slowdown rather than recession.
- We also saw the Eurozone moving away from danger with the announcement of bigger haircuts on Greek government bonds, recapitalisation of the banks and an increased bailout fund (EFSF). More detail is needed, but the area has made two of the steps we highlighted in the last Viewpoint. The third step, reflation, has yet to come. The "leap" of fiscal union is slowly on its way.
- As expected, the Bank of England has embarked on another round of quantitative easing and there is speculation that the US Federal Reserve is about to launch QE3. We remain sceptical on the benefits of QE and highlight the adverse effect it is having on savers, particularly pension funds in the UK where the policy exacerbates funding deficits.

### Eurozone: Are we there yet?

- The latest solution for the European sovereign debt crisis has been unveiled, and though it is missing a lot of details, it covers the three pillars of a solution that we have been looking for. The announcement re-enforces our view that politicians are willing to take unprecedented action to keep the European Monetary Union together.
- One of the key reasons behind the loss in confidence of markets has been the weaker than expected growth, and as a result, worse than expected fiscal outturn. Greece is running a larger deficit than it did a year earlier, though the rest of the periphery seems to be faring better.
- Meanwhile earlier this month, the ECB kept interest rates on hold but restarted 1-year liquidity auctions, and announced €40 billion worth of covered bond purchases. The additional support for the banking system will be useful, though we also expect the ECB to keep buying peripheral bonds.

### Chart: US economic surprise index turns up



Source: Citigroup, Bloomberg, 27 October 2011.

# Global

**Global growth looks firmer...**

**...as supply chain and commodity shocks fade**

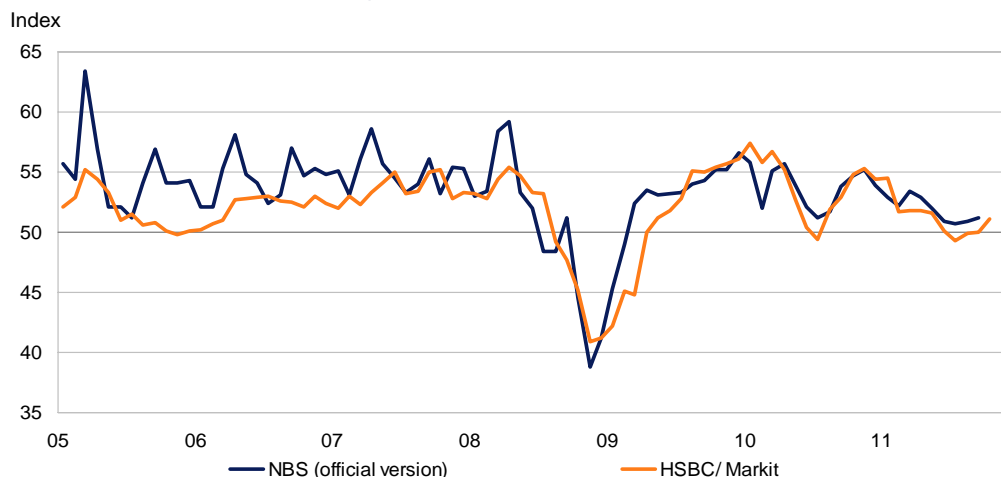
## Back from the brink

Having been too optimistic about the growth outlook for much of the year, recent data has been more supportive of our view that the US economy will avoid a recession. Despite the collapse in equity markets during the third quarter, businesses continued to hire and households went out and spent. The employment report showed an increase in payrolls of just over 100,000, the ISM index remained in expansion territory, and retail sales made healthy gains in September.

So far the fall in consumer confidence does not seem to have led to a retrenchment in spending. Overall, the US economy grew by 2.5% (annualised) in the third quarter and whilst this might seem like ancient history, it is a far more resilient outcome than markets were expecting during the summer. The economic surprise index for the US has improved as a result (see chart on front page) and growth forecasts are expected to stabilise.

Meanwhile, growth in China is holding up with the economy expanding by 9.1% y/y in the third quarter, a slowdown from the 9.5% achieved in the second, but by no means a hard landing. Industrial production and retail sales both picked up pace in September. The PMI's point to modest growth but remain well above the levels seen in 2008 (chart 1).

### Chart 1: China manufacturing PMIs



Note: NBS (National Bureau of Statistics). Source: Thomson Datastream, Markit, 27 October 2011.

Our view that an easing in supply chain disruption (post the Tohoku earthquake) and a moderation in inflation (post the surge in food and energy prices) would lift growth now seems to be playing out.

## Euro crisis: impact on rest of the world

**Euro crisis: step forward at Brussels**

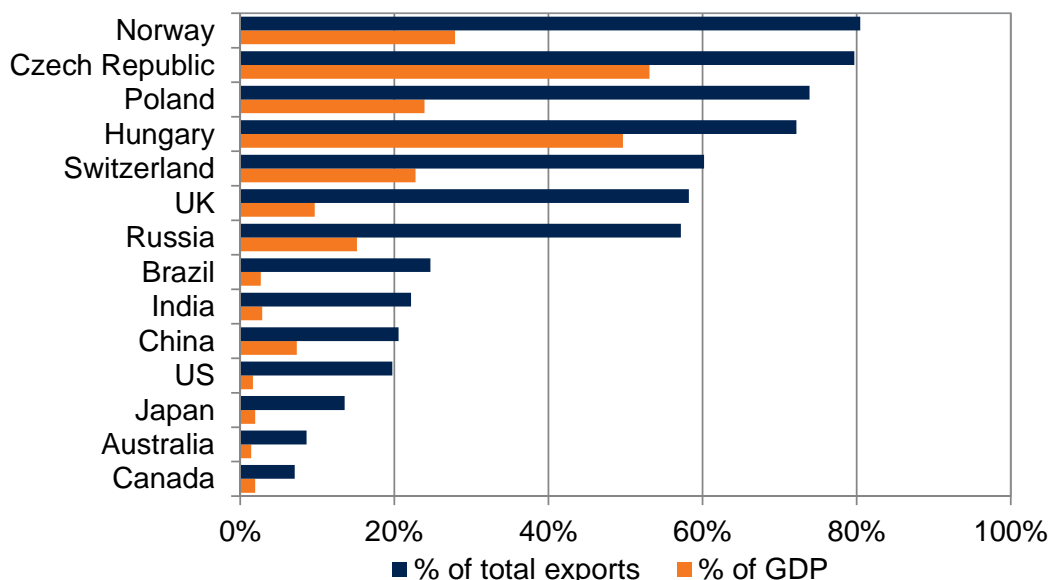
Until very recently, investors have been held back by the Euro crisis. At the time of writing we have just had the announcement from the Brussels summit where agreement on the size of the Greek haircut (banks to 'voluntarily' accept a 50% write off) and bank recapitalisation (€106 billion needed by next June) has been achieved, but no details on how to leverage the bailout fund (EFSF) up to the €1 trillion announced by President Sarkozy.

**Risk of a credit crunch added to headwind from fiscal austerity**

We discuss the latest developments in the Euro area section below, but suffice to say that there are still significant risks in the region. Fiscal policy is tightening, monetary stimulus is weak and it is not possible to rule out a recession driven by a credit crunch as banks de-lever in response to haircuts and the EU's demand to bolster their capital positions. Anecdotal evidence suggests that many banks would choose to reduce their assets rather than raise more capital at this point in the cycle.

Should the Euro area go into recession, there would be a significant impact on the rest of the world. The region accounts for nearly a quarter of global GDP and has significant trading links. In terms of vulnerability to a fall in Eurozone demand, the most affected would be the countries of Eastern Europe (including Russia), Scandinavia, Switzerland and the UK with exports to the Eurozone ranging from 10% to nearly 30% of GDP. In the emerging world, China is the most affected with exports to the Euro area accounting for 7.3% GDP, well ahead of the US where the equivalent figure is just 1.6% GDP (chart 2).

**Chart 2: Trade links with the Euro area**



Source: Schroders, Thomson Datastream, 27 October 2011.

In terms of the forecast such figures highlight the vulnerability of the world economy, particularly the rest of Europe and, more surprisingly, China to a recession in the Euro area. Following a recent trip, we found increasing concern in Asia over the Euro crisis. If we add in the banking links, then it is not surprising that Euro zone politicians are feeling pressure from their counterparts elsewhere.

### **Greater role for China via the IMF?**

Whilst the authorities in China have declined to get directly involved in supporting the region, probably as a reaction to their experience supporting US banks during 2008, it is possible that we see greater indirect involvement through the IMF. The latest crisis provides an opportune moment for China and the other BRICs to increase their influence at the Fund. Certainly it is difficult to see the members of the Euro zone coming up with significantly more funding without serious damage to their creditworthiness. Increased IMF involvement would help bridge the gap.

### **Does QE really work?**

### **Quantitative easing back on in the UK, on the agenda in the US**

Meanwhile, in response to the earlier slowdown central banks are currently focussed on easing monetary policy. The growth picture may have improved, but it is still one of sub trend activity and there are also concerns that the risks are still skewed to the downside. As expected the Bank of England was the latest to move by announcing on the 6th October a second round of quantitative easing (QE) where they will purchase £75bn of nominal gilts over a four month period.

There is also speculation that the US Federal Reserve will launch a third round of QE following comments from governor Janet Yellen. Although only one member of the committee, she and NY Fed governor Dudley are seen as closest to Fed chair Bernanke and hence have a major influence over policy.

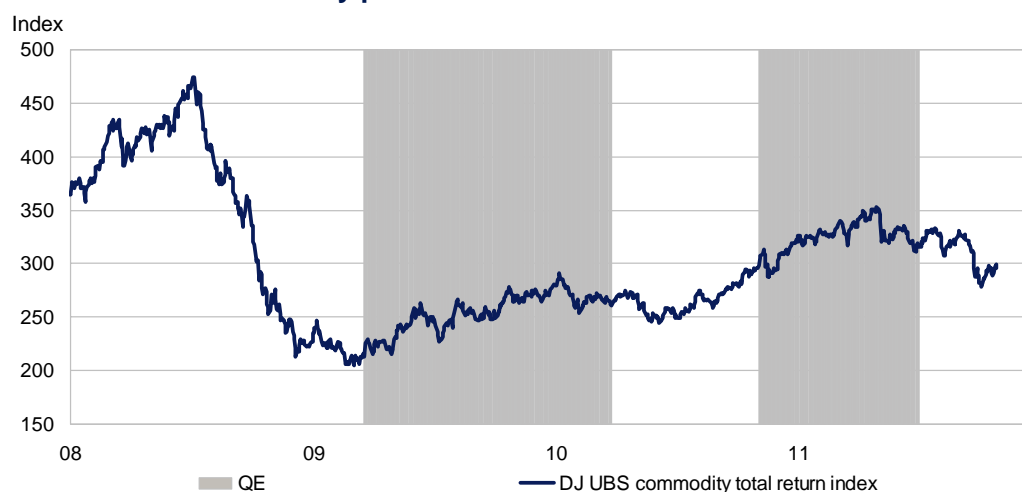
***We continue to doubt its efficacy and can see negative as well as positive effects***

We still have serious doubts about the effectiveness of QE and do not share the Bank of England's view that the previous round significantly boosted nominal growth<sup>1</sup>. The increase in money supply created by QE operations has become stuck in the banking system, rather than leading to an increase in lending and activity. The principal mechanism from QE to activity would seem to come via the exchange rate as, by launching asset purchases, the central bank is signalling that interest rates are likely to remain lower for longer hence, in this case, weakening the pound.

In the US, there is the added link through asset prices as Fed moves toward QE have increased risk appetite. It is hard to argue though that the Bank of England has such influence over global investors.

We would also highlight two adverse effects from QE which work against the aim of policy. The first is the effect on commodity prices which have surged each time the Fed launched QE in March 2009 and November 2010 (chart 3). The effect would seem to be tied to the weakness in the US dollar which has driven investors into commodities. The rise in commodity prices then squeezed real incomes at a time when households were de-leveraging, contributing to the world economy stalling in the summer.

**Chart 3: QE and commodity prices**



Source: Schroders, Thomson Datastream, 27 October 2011.

### **Financial repression: beggar thy saver**

***QE is bad news for pension funds and savers***

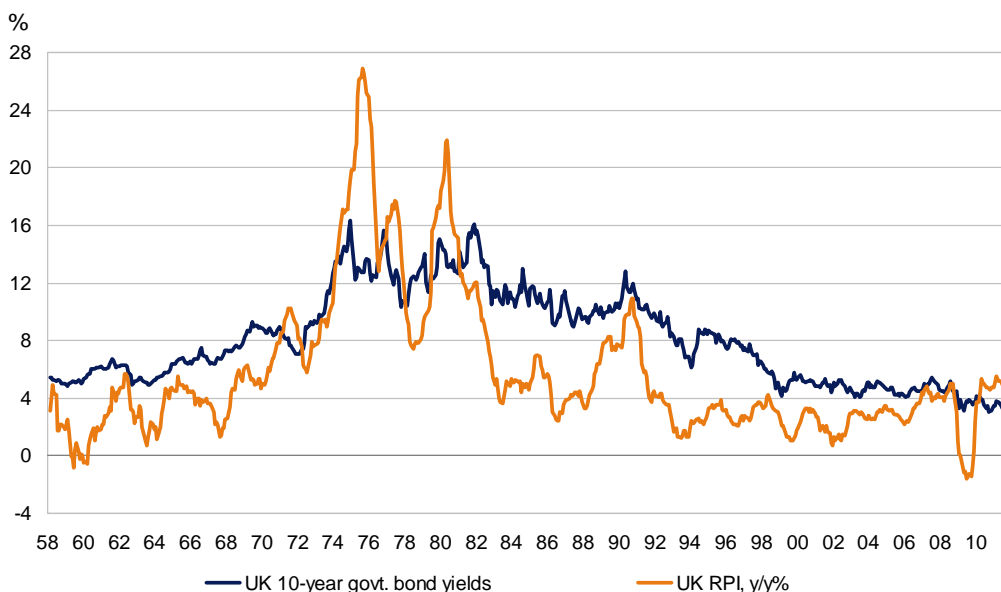
The second effect has been less widely discussed but could be equally adverse for growth. By driving down interest rates on bonds the central bank is adding to pressure on pension funds. In the UK the National Association of Pension Funds (NAPF) has estimated that QE will result in a net £45 billion increase in pension fund deficits.

The reduction in yields reduces future returns whilst simultaneously raising the net present value of liabilities. Although there should be some offset from higher asset prices, the net effect is to make a difficult situation for the UK's pensions industry even worse. Should pension funds need to plug this increase in deficit the effect would be to raise pension contributions by 3% GDP - money that could be used to increase investment or employment.

The problem in the UK has been made worse by the high rate of inflation, which at 5.6% is well above gilt yields. Negative real yields are obviously bad for savers, but particularly pension funds who have inflation linked liabilities.

<sup>1</sup> See "Back to the printing press", Schroders Economic and Strategy Viewpoint 30 September 2011

**Chart 4: Gilt yields and inflation**



Source: Schroders, Thomson Datastream, 27 October 2011.

We would see this as part of the wider pressure being felt by savers who face a prolonged period of negative interest rates in our view. To gain a real return investors now have to move out of cash and high quality government bonds into risky assets.

The responsibility for QE and the control of inflation lies with the Bank of England. The Bank, of course, is favouring debtors in its desire to speed the process of de-leveraging in the public and private sector through lower gilt yields and mortgage rates. However, savers are being penalised as a result.

From a short run macro point of view this does not matter if the loss of £1 to a saver results in less of a cut back in spending, than the same loss to a borrower. Given that borrowers tend to be liquidity constrained, such that extra costs have to be found from current expenditure, this condition probably holds. Nonetheless, this is a form of financial repression where savers pay for the errors of borrowers.

# Eurozone

## Eurozone: Are we there yet?

Finally, we have more information on how European leaders will proceed in tackling the sovereign debt crisis. Hopes of a resolution were dashed after the 21st of July announcement once markets had realised that those plans were a long way from being turned into policy. In the mean time, the Eurostoxx50 index has fallen by 15%, while the 10 year yield for Italian government bonds has risen by approximately 56 basis points<sup>2</sup>.

## The new deal

As we are writing this month's edition, leaders from the Eurozone and the wider EU met to thrash out a solution that they hope can finally stem the contagion spreading from the European sovereign debt crisis. In the early hours of the 27<sup>th</sup> of October, an announcement was finally made that followed the three pillars we set out in the September Economic and Strategy viewpoint. The agreement includes:

- Private investors will be asked to voluntarily partake in the restructuring of Greek debt, which will be the equivalent of taking a 50% nominal haircut.
- The European Financial Stability Facility (EFSF) will be made more effective by 1) offering insurance on new government debt to be issued and 2) being increased in size using a Special Purpose Vehicle, which both public and private money will fund.
- European banks will be forced to meet a new higher Tier 1 capital ratio of 9% but with regulators ensuring that the deleveraging process does not involve a reduction in credit to the real economy. Banks are asked to raise capital from private investors first, and failing that, receive help from national governments. €100bn of loans will be made available from the EFSF.

In addition to the above, the changes to the EFSF's powers agreed on the 21st of July are now in force. This means that the EFSF can buy bonds in secondary markets either in conjunction with, or taking over from the European Central Bank.

Finally, plans were announced to increase political and fiscal integration, mainly through more scrutiny of fiscal plans through the existing peer review process. We believe that these are the first steps towards a fiscal union, though we may be many years away from the model being completed.

In our view, these are very positive steps in the right direction which reinforces our view that European politicians are willing to take unprecedented action to keep the European Monetary Union together. However, the deal is not totally finalised, and we must wait for more details on each of the three pillars of the solution.

For example, the eventual lending capacity of the EFSF has yet to be agreed. Hints of increasing its current lending capacity of between €200 billion and €250 billion by three or four fold have prompted headlines of €1 trillion being made available. Certainly if the insurance strategy only covers the first 20-25% of losses on peripheral sovereign debt, then this would be the case. €1 trillion would be enough to support Italian and Spanish funding until around 2014. The problem with this assumption is that it relies on the market being willing to buy the bonds with the insurance - which is not guaranteed. Moreover, how will investors feel about insurance schemes and guarantees if Greek debt has been restructured on a 'voluntary' basis, hence not triggering credit default swaps (CDS).

***Eurozone leaders have finally announced a more comprehensive package that has a chance at stemming the crisis...***

***...however, the deal has not been finalised, and we await a lot of the missing details.***

<sup>2</sup> Correct as of close on 26/10/2011.

***With a 50% haircut on private investors, Greece hopes to return to debt-to-GDP of 120% by 2020.***

The full details of the Greek restructuring are unlikely to be available until the end of the year, with the EU targeting implementation at the start of 2012. It appears that the announced measures have the support of the vast majority of creditors. However, we still have no confirmation of the extent of the voluntary take up. The hope is that taking the haircut together with Greece's austerity programme and the support provided by the EU and IMF, Greece will be able to reduce its debt level to 120% of GDP by 2020. We would argue that this level is still too high and that haircuts on publically owned Greek debt will be required. Why target 120%? Probably as it makes Italy appear more sustainable than it actually is.

The deal announced also provides a green light now for Greece to receive its September tranche of loans, which the IMF has already agreed to disburse. Interestingly, we will now see a permanent presence of the Troika (ECB, European Commission, IMF) in Athens to help with the implementation of fiscal and structural reforms.

***The deal may not be perfect, but it looks like the Eurozone has dodged another credit crunch, and a very serious recession.***

Other details that are missing include:

- How will the IMF respond to the deal? Will it also provide additional funding?
- What happens if the funding cost of the EFSF rises? Will the EU pass on the increased cost to the bailed out governments?
- What role will the ECB play going forward? Is it still expected to purchase government bonds even though the EFSF now has the power to do so?

Overall, there are a lot of details still missing from the plan, though we are encouraged that European politicians are moving in the right direction. The deal should help reduce the volatility in financial markets, though the damage may have already been done to the real economy. We expect the Eurozone economy to slow significantly by the end of the year, though the deal done may have helped avoid a second global credit crunch and a very deep recession.

### **Is austerity working?**

***In addition to political uncertainty, lack of progress on Greece's fiscal targets has hit confidence***

The woeful dithering by European politicians over the past few months have fanned the flames of uncertainty, but in addition, the lack of growth in peripheral Europe has been one of the key reasons behind the market's loss of confidence.

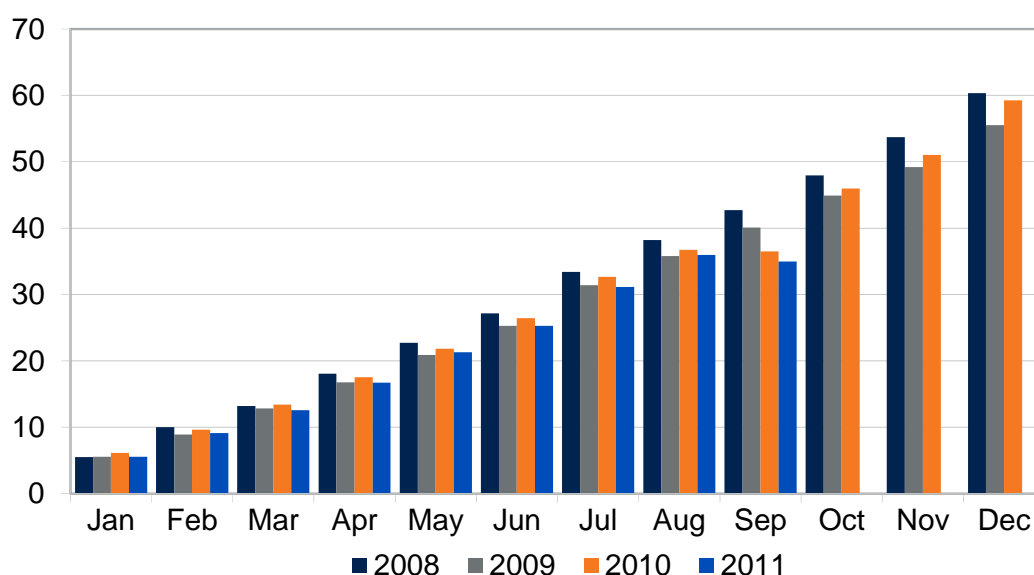
Weak or no growth in these troubled economies means that public finances suffer on two fronts. Tax revenues underperform as households and corporates hold back consumption and investment. Meanwhile, austere spending plans take a hit as social security payments increase as unemployment rises. Of course, some allowance is made for these factors in the official fiscal forecasts, but if growth disappoints as it has done, then these forecasts will be found wanting.

The focus is rightly on Greece, which is now approaching 18 months of austerity. The haircuts being discussed will help reduce the country's debt burden, but given that Greece has been largely absent from markets since May 2010, its public finances should not have been directly affected by the rise in Greek government bond yields.

Nevertheless, Greece's huge effort in trying to raise its tax revenues has failed. As chart 5 shows, tax revenues in September were €1.5 billion lower than those raised in the same month a year earlier.

**Despite increasing tax rates, Greek tax revenues are lower than they were a year ago...**

**Chart 5: Cumulative Greek government tax revenues (€bn)**



Source: Greek Ministry of Finance, Thompson Datastream, Schroders. Updated 28 October 2011.

The fall in tax revenues despite the increases in taxes has been a damaging blow for the Eurozone's plans to tackle the crisis. It appears that Greece may be close to the peak of the Laffer curve - an economic relationship which examines the relationship between tax revenues and the effective tax rate in the economy. The theory suggests that as tax rates increase, fiscal policy yields diminishing returns in terms of tax revenues. However, once the peak of the Laffer curve is reached, any additional increases in tax rates lead to falls in tax revenues - therefore highlighting that there is a limit to fiscal policy.

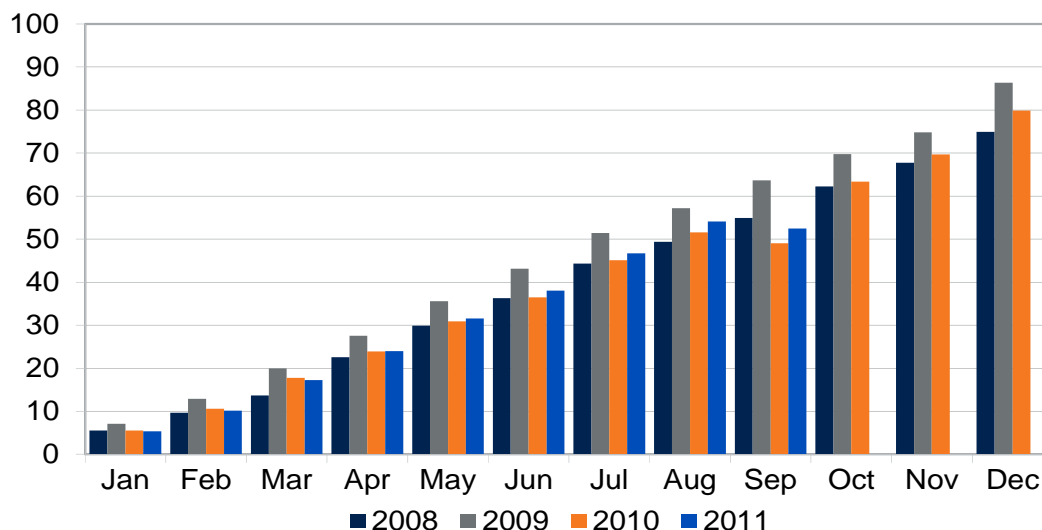
Some of the falls in tax revenues have been linked to the poor implementation of fiscal reforms in Greece. This is why the Troika is now likely to have a permanent presence in Athens as mentioned above. In addition, a small fall in tax revenues should not come as a surprise given the economy could shrink by around 7% this year.

In any case, the only thing more disappointing than the fall in tax revenues has been the lack of progress in cutting public spending, after all, this is really where Greece has let fiscal policy slip over the past decade. Despite the calls for tighter controls, public spending in Greece was €3.4 billion higher in September compared to the same month a year ago (see chart 6 on next page). €3.4 billion represents a 7% increase in spending, which even when adjusting for the 2.9% annual inflation rate, is still a disappointing increase in real terms.

Similar to the negative impact the deeper than expected recession has had on the revenue numbers, the shortfall in growth has meant unemployment rising faster than anticipated, and as a result, more people claiming social security benefits.

*...while public spending has risen compared to last year.*

**Chart 6: Greek government spending (€Bn)**



Source: Greek Ministry of Finance, Thompson Datastream, Schroders. Updated 28 October 2011.

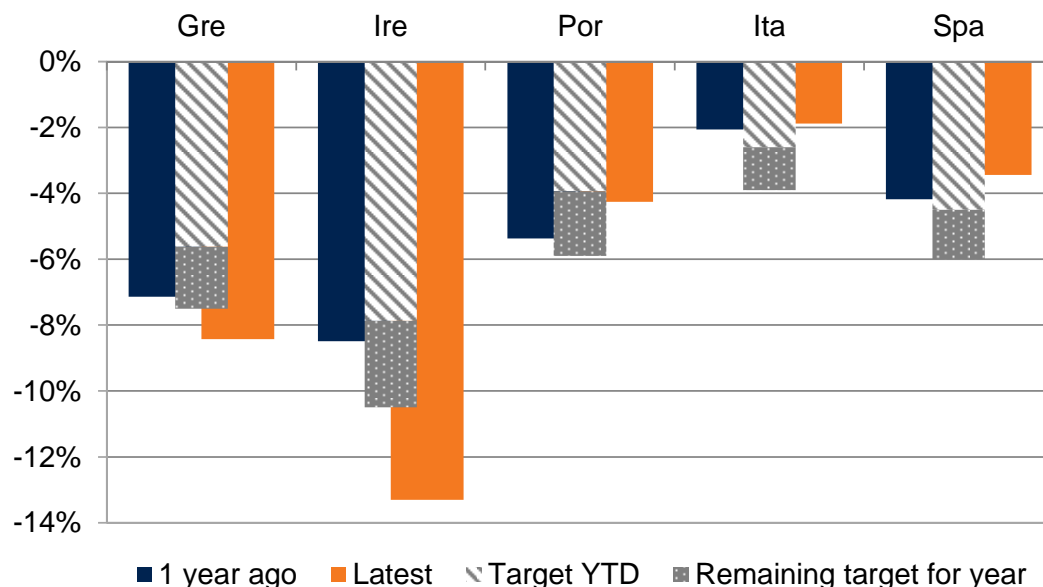
**Peripheral fiscal targets**

Given the above, it is no surprise that Greece is highly likely to miss its fiscal target for 2011. Looking further amongst the periphery, we find that Portugal and Ireland are behind their respective targets (pro-rata for the year), where as Italy and Spain are ahead of theirs.

Chart 7 below shows the current fiscal position as a share of nominal GDP (orange columns), plotted against the equivalent position a year earlier (blue columns), versus the target year-to-date, and the remaining target for the rest of the year (middle grey columns).

*Elsewhere in the periphery, Italy and Spain are ahead of their fiscal targets.*

**Chart 7: Latest deficits vs. year earlier vs. targets (% of GDP)**



Latest cash deficit numbers from Greece, Ireland and Spain are for September, rest are for August. Nominal GDP taken for latest 4 quarters of data (Q2 2011 for all except Greece, Q1). Target YTD calculated as pro-rata of 2011 year end target.  
 Source: National ministries of finance and economy, Thompson Datastream, European Commission, Schroders. Updated 28 October 2011.

It is worth noting that the Irish case is a little more complex than it appears on the above chart. The Irish plan to recapitalise its banking system ended up costing more than originally assumed when its fiscal target was set. The total amount injected into the banks earlier this year came to €18 billion, which is worth 11.6% of GDP using the same base for the chart's calculations. This means that if Ireland makes no further improvements and does not have to put any more money in the banking system, then it could have a deficit of just 1.7% by this time next year. These results coupled with two consecutive quarters of positive growth have helped bring down the cost of borrowing for Ireland over recent months.

Overall, with the exception of Greece, most of the peripherals are broadly on track to meet this year's fiscal targets. Portugal is slightly behind, though some of this is related to changes in the definitions of certain public enterprises.

### ECB back in action

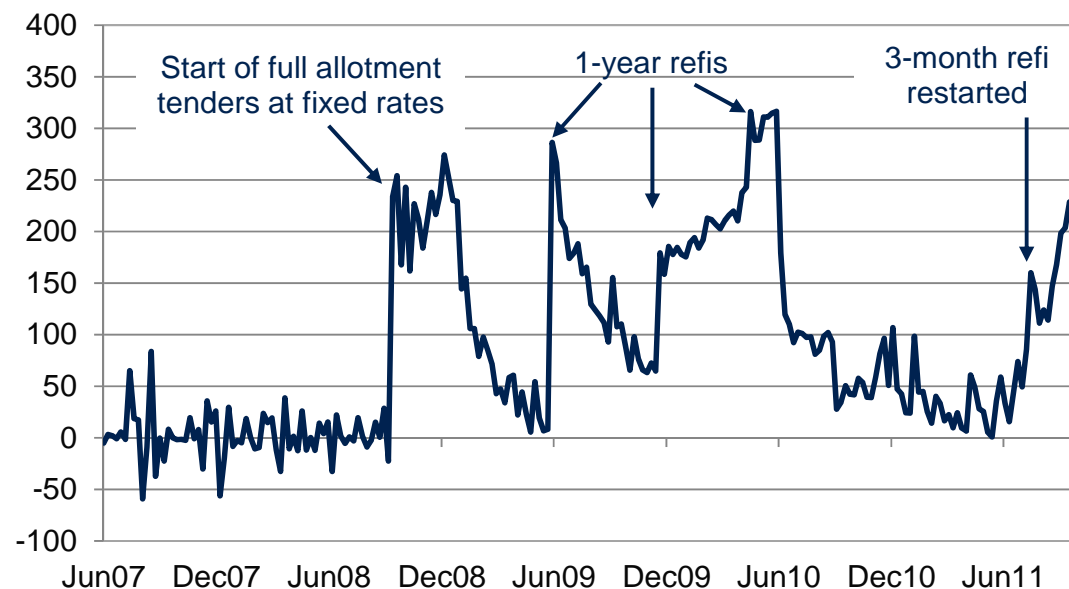
Earlier this month and in his final meeting as ECB president, Jean-Claude Trichet disappointed markets by not cutting its main policy interest rate of 1.50%. The keeping of rates on hold was in-line with our forecast, and so was the announcement that the ECB will be conducting two new one-year unlimited liquidity auctions designed to provide longer-term funding for the ailing European banking system. In addition to the new liquidity measures, the ECB also revealed that it would be buying €40 billion of covered bonds, which are also positive for the banking system.

The increase in dependence on the ECB by the banking system has been alarming and was one of the key signals that the latest plan had to have an element that address the balance sheets of the banking system.

Chart 8 shows the amount of excess banking reserves that is being held at the ECB. As banks access the new liquidity from the ECB, they have been choosing to park the cash with the central bank rather than put it to work in the real economy. This is one of the reasons why the EONIA-LIBOR spread has risen - banks becoming less willing to lend to one another.

**Chart 8: Excess banking reserves held at the ECB (€bn)**

*Meanwhile, the ECB is helping the banking system by restarted its liquidity auctions...*

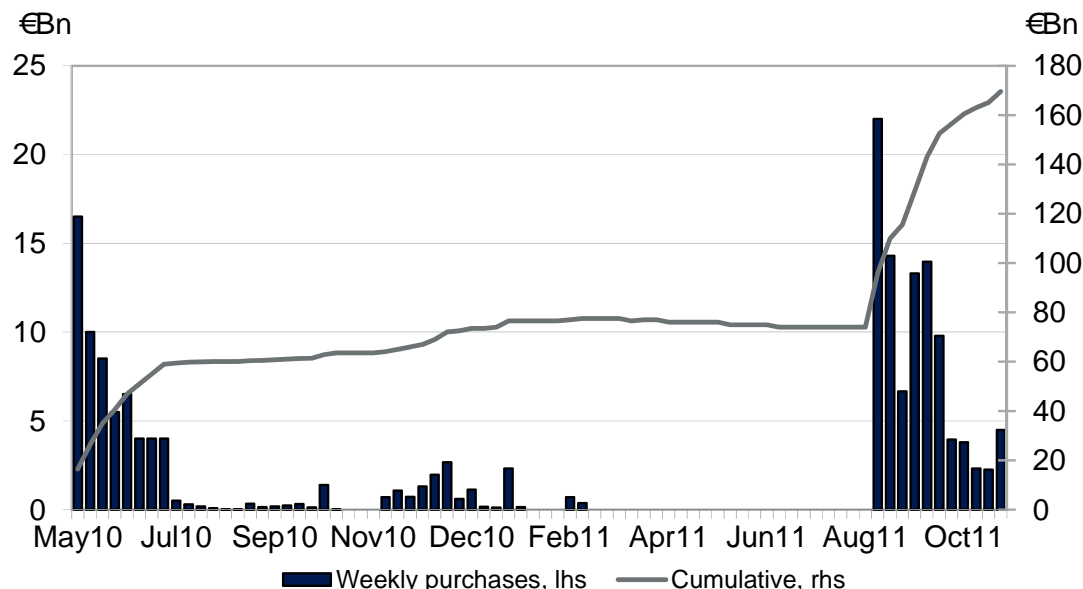


Source: European Central Bank. Updated 29 September 2011.

In addition to the new longer-term liquidity that will be provided, the ECB has continued to buy peripheral bonds, albeit at a slower pace (see chart 9 below). Now that the EFSF can buy bonds on the secondary market too, hawkish members of the ECB's governing council may now push for a complete stop of bond purchases. However, we believe that the ECB will continue to support these markets with more purchases.

*...and continuing to buy peripheral sovereign debt.*

**Chart 9: ECB bond buying**



Source: European Central Bank. Updated 29 September 2011.

What of interest rates? As we argued in the August Economic and Strategy Viewpoint, there is little meaning in cutting interest rates, as money market rates are trading well below the official rate of 1.50%. Trichet and the ECB have been consistent in their use of policy tools and their separation principle: interest rates used to manage price stability, while nonstandard measures such as the liquidity auctions used for credit and banking problems.

Looking ahead, it will be interesting to see if the new incoming president Mario Draghi will change the direction of policy towards interest rates and the use of the ECB's balance sheet.

**I. Forecast summary****Real GDP**

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	3.0	1.8	1.7	2.4	1.9
UK	4.1	1.4	0.9	1.0	1.5	1.5
Eurozone	23.5	1.7	1.7	1.6	1.0	0.6
Japan	9.5	4.0	-0.5	-0.5	2.7	2.2
OECD	63.5	2.6	1.4	1.3	1.9	1.5
China	9.1	10.4	9.0	9.1	8.5	8.5
Emerging*	36.5	7.6	6.1	6.1	6.0	5.6
World	100.0	4.4	3.1	3.0	3.4	3.0

**Inflation CPI**

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	1.6	2.6	3.1	1.3	2.1
UK	4.1	3.3	4.6	4.4	2.6	2.7
Eurozone	23.5	1.6	2.7	2.6	1.8	1.8
Japan	9.5	-0.7	-0.2	-0.2	0.0	-0.2
OECD	63.5	1.4	2.3	2.5	1.4	1.7
China	9.1	3.3	5.0	5.4	3.8	4.0
Emerging*	36.5	5.2	6.2	6.0	5.5	5.3
World	100.0	2.8	3.8	3.8	2.9	3.0

\* **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-10	Dec-11	Market	Dec-12	Market
US	26.4	0.25	0.25	0.55	0.25	1.90
UK	4.1	0.50	0.50	1.10	0.50	1.11
Eurozone	23.5	1.00	1.50	1.38	1.50	1.12
Japan	9.5	0.10	0.10	0.32	0.10	0.32
OECD	63.5	0.52	0.71	0.86	0.71	1.32

Market data as at 26/10/2011

**Key variables**

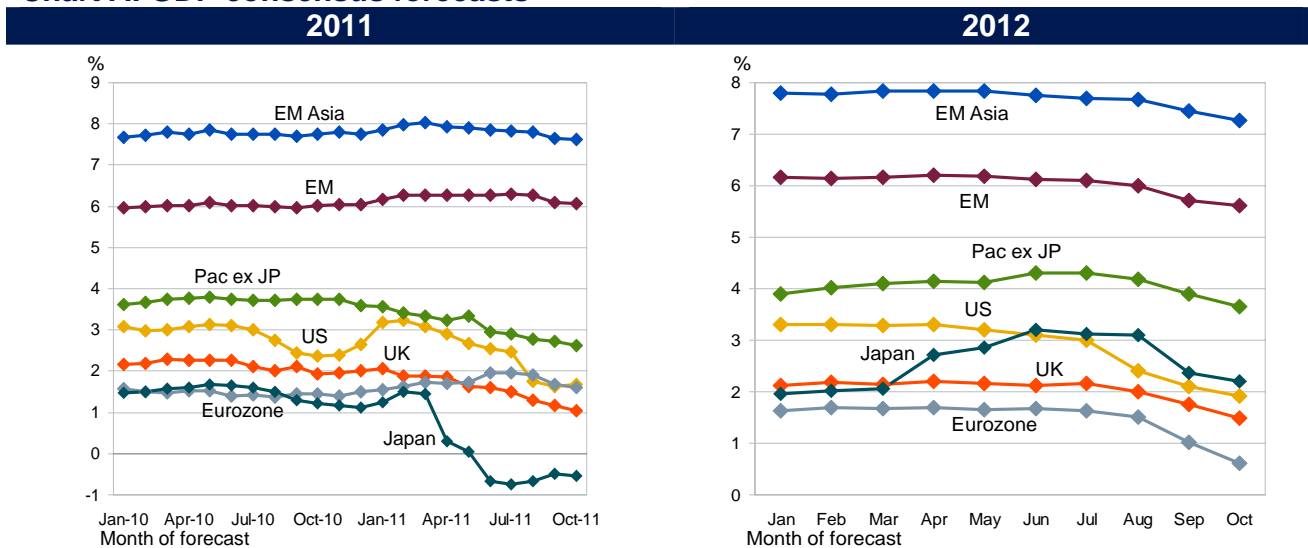
FX	Current	Dec-10	Dec-11	y/y%	Dec-12	y/y%
USD/ GBP	1.60	1.60	1.55	-3.1	1.50	-3.2
USD/ EUR	1.38	1.34	1.30	-3.0	1.28	-1.9
JPY/ USD	76.2	83.0	75.0	-9.6	75.0	0.0
GBP/ EUR	0.87	0.84	0.84	0.1	0.85	1.3
Brent crude	111.9	87.2	101.6	16.6	94.9	-6.6
US output gap %GDP	-5.5	-6.4	-4.9		-4.4	
Unemploy. %	9.1	9.6	8.8		8.6	

Source: Schroders, Datastream, Consensus Economics, October 2011

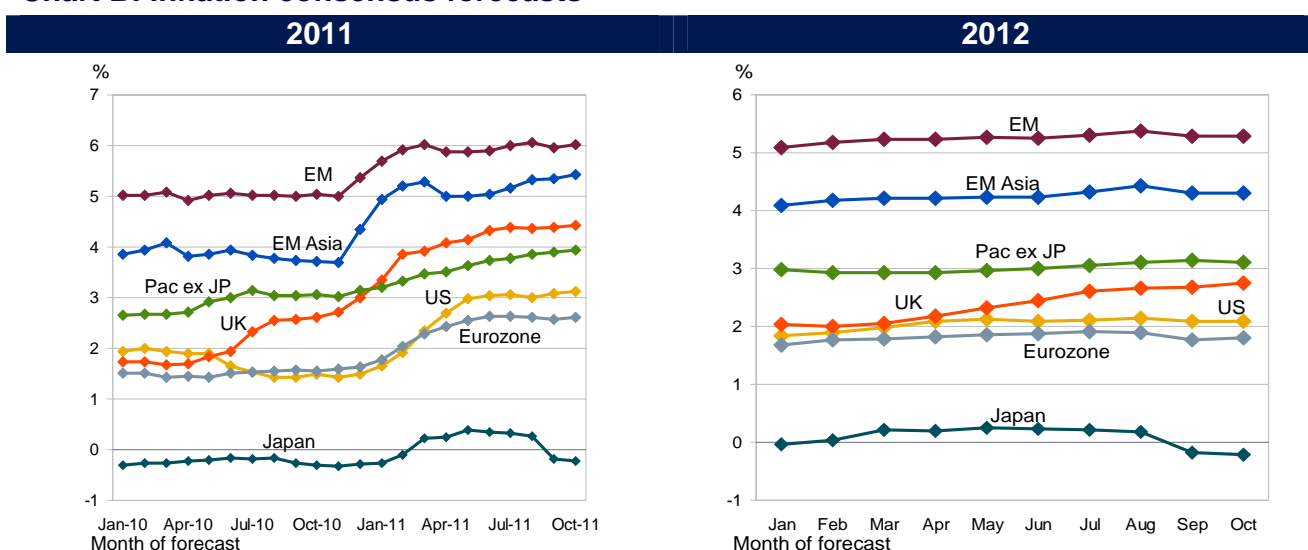
## II. Updated forecast charts - Consensus Economics

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, Schroders, October 2011

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

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore

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