



Economic and Strategy Viewpoint

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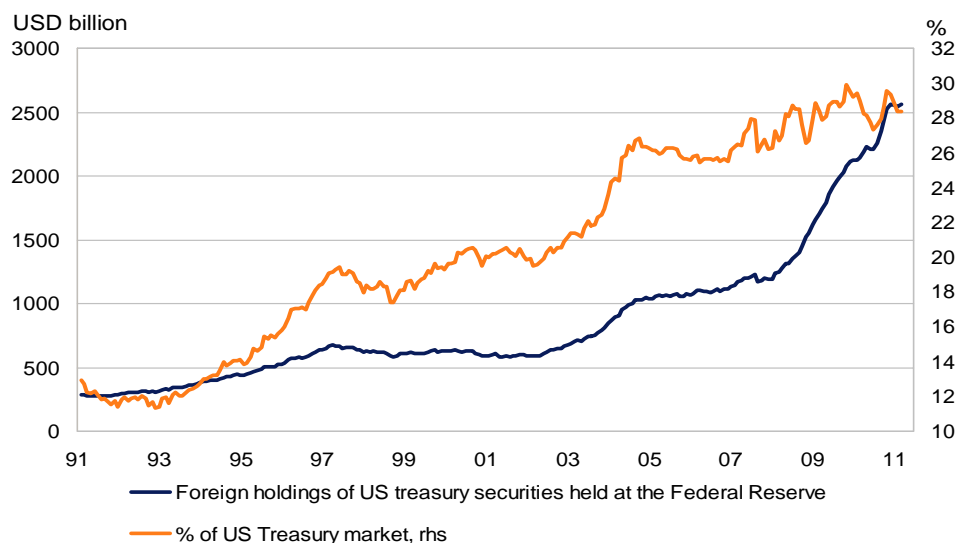
Global: Will the US remain AAA?

- The decision by Standard and Poor’s (S&P) to put the Treasury bond market on negative watch should act as a wake up call to US politicians who continue to haggle over fiscal consolidation. More generally, it is a reminder that in “solving” the financial crisis, advanced country governments have taken a huge amount of debt onto their own balance sheets. Going forward, the success of efforts to reduce budget deficits will largely depend on growth and investor confidence.
- On the growth front the outlook for economies such as the US and UK is far less favourable than during the last period of fiscal consolidation in the 1990s. Today real incomes are being squeezed and savings rates are under upward pressure from the desire to repair balance sheets. Too many countries are looking for trade to pull them through, an outcome made less likely when most are also engaged in fiscal consolidation of their own.
- The key though remains investor confidence. Real interest rates remain low and there seems to be little default premium built into major advanced country bond markets. This is at odds with econometric studies, which suggest that the rise in debt-GDP ratios should have triggered an increase in real yields. Low policy rates and the lack of demand for credit from the private sector are factors behind this. Key to the ability of the US to preserve its current rating though will be the attitude of foreign central banks who continue to allow the US dollar the exorbitant privilege of being the world’s reserve currency.

Europe: Staring into the abyss

- Portugal has an enormous challenge ahead of it in winning back the confidence of investors. Its problem is ballooning public sector debt and a lack of growth. The European Central Bank raising interest rates has not helped either, but denial over lower trend growth, and possibly permanently higher borrowing costs risks reducing the likelihood of a successful austerity programme.
- Greek debt default fears have returned, though we believe that restructuring in the near term remains unlikely. Greece is still heavily reliant on external financing, and a default now could cause an EU-wide populist backlash against other bail-outs.
- Portugal is staring into the abyss, and there is a real risk it finds itself repeating past mistakes and following Greece along a path towards restructuring.

Chart: "Exorbitant privilege" - foreign central banks fund the US



Source: Thomson Datastream, 26 April 2011

Global

Global: Will the US remain AAA?

Threat to AAA status of the US

The decision by S&P to put the US Treasury's AAA rating on negative watch was a reminder of the problems facing many advanced country governments. In this case though, the move was triggered by the lack of progress being made by Congress on agreeing a plan to achieve fiscal sustainability and the urgent need to lift the debt ceiling to avoid the possibility of a technical default. More generally, the S&P move is a reminder that in tackling the financial crisis, governments have taken a lot of debt onto their own balance sheets.

Europe is already taking action

Many see the S&P move as a positive for bonds as it could galvanise US politicians into taking a more responsible approach toward the government deficit. US Treasury yields are now back to their pre-announcement levels, although the US dollar is lower in trade-weighted terms. In this month's Viewpoint, we look at the macro factors which will determine the success of policies to reduce government debt, not just in the US, but more broadly. It must be said that outside the US, governments are taking deficit reduction more seriously, particularly in Europe where programmes are already underway to bring down government deficits. The UK is a case in point where the government recently updated its plans to deliver a reduction in borrowing from around 10% of GDP to 1.5% of GDP over the next 5 years (see charts 1a and b).

Chart 1a: Public sector borrowing – structural vs. cyclical

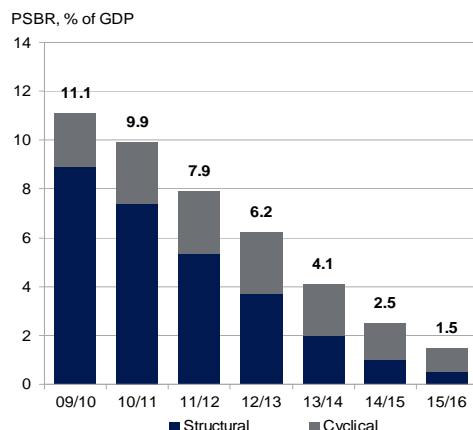
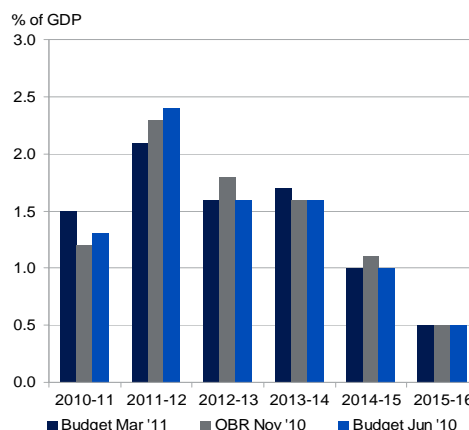


Chart 1b: Change in UK cyclically-adjusted budget deficit



Source: ONS (UK Office of National Statistics), Thomson Datastream, OBR (Office for Budget Responsibility), March 2011, Schroders, 30 March 2011

Easier to reduce debt when growth is robust

The first factor is growth. Whilst much of the budget deficit in advanced countries is structural, and so will not improve with economic recovery, the ability of governments to tackle structural deficits is much greater when the economy is growing. Reducing entitlement programs is more palatable when employment and incomes are buoyant.

...unlike today

History bears this out, as periods where budget deficits have been significantly reduced have been associated with healthy if not strong growth. For example, according to the Bank for International Settlements during the last period of successful US fiscal adjustment between 1993 and 2000 where the budget deficit was cut by nearly 5% GDP, the economy grew 4% per annum. Similarly, the UK achieved an even greater reduction in borrowing of 7.7% of GDP between 1994 and 2000 against a backdrop of 3.5% annual growth.

Today, the prospects look far less promising as US growth forecasts are being cut to less than 3% for this year, whilst the UK is looking at less than 2%. The difference is that during the 1990s both the US and UK benefited from a strong tailwind as credit and property markets boomed. Loose monetary policy helped to accommodate the tightening of fiscal policy.

Many are looking to overseas demand to drive growth

In the present environment, post the financial crisis, households are still deleveraging and consequently the boost from domestic demand is considerably less. The combination of tax increases and the rise in inflation makes it difficult to see how consumers can support the economy as real incomes fall. In the UK, real incomes are some 2% lower than a year ago and real consumption growth has only been maintained by a drop in the savings ratio.

Going forward the savings rate may fall further as in the official forecasts, but there is clearly a risk that households decide to save more thus reducing consumption. The latest dip in consumer confidence suggests this is a real possibility (see charts 2a and b). Note how the savings rate fell during the last fiscal consolidation phase in the nineties. Like many countries, the UK is looking to overseas demand to support growth and 0.7 percentage points of the 1.7% GDP growth expected by the Office for Budget Responsibility this year is forecast to come from net trade. The fact that many of the UK's trading partners are also engaged in fiscal consolidation makes this less achievable.

Chart 2a: UK consumption growth and disposable income

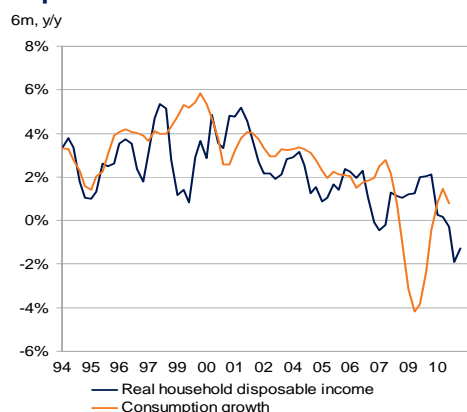
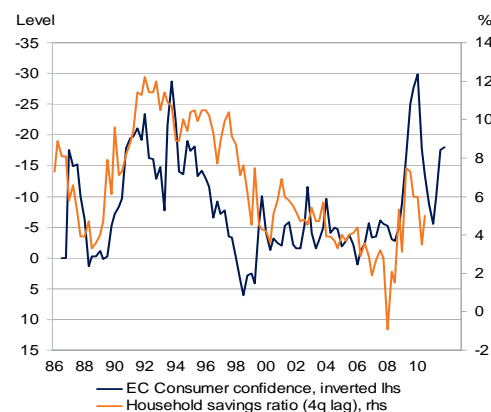


Chart 2b: UK savings ratio and consumer confidence



Source: ONS (/UK Office of National Statistics), Thomson Datastream, 5 April 2011.

..and want a weak currency

Real rates are low despite the rise in government debt

The US is in a similar situation with weak real income growth, although the savings rate has probably adjusted further and employment growth is beginning to support household incomes. However, the willingness of the US authorities to see the US dollar slide is an indication of their need to draw in demand from overseas.

The second factor is interest rates and investor confidence. Highly indebted borrowers require a low rate environment to sustain their finances. In general, an economy facing a real interest rate in excess of its long-term trend rate of growth faces considerable problems. Here the prospects are more favourable as despite an increase in government debt to GDP of some 25% for the advanced economies since 2007, real yields remain low. This is something of a puzzle as econometric analysis by the IMF suggests that such an increase in government borrowing would push up real yields. It would appear that in accepting such yields investors are confident that governments will be able to service their debts.

Underpinned by low short rates...

Two explanations can be made. The first is simply that policy rates are low and act as an anchor on longer-term rates. Given real short rates of less than zero, long rates of 2% still imply a steep yield curve. From an investor point of view, the cost of shorting bonds is expensive (see charts 3a and b).

Chart 3a: G7 real short rate

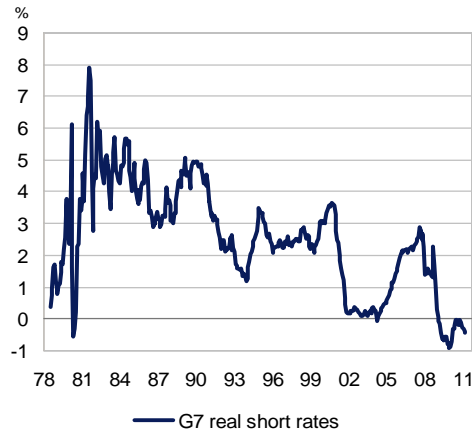
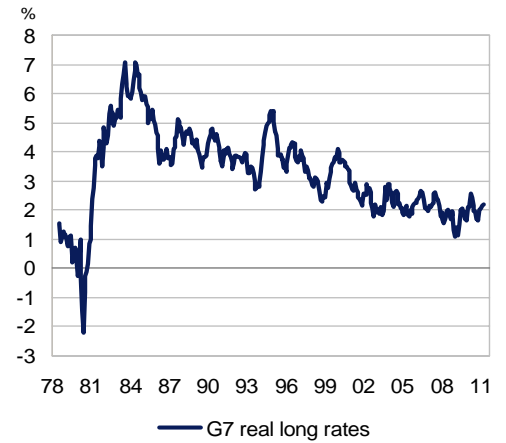


Chart 3b: G7 real long rate



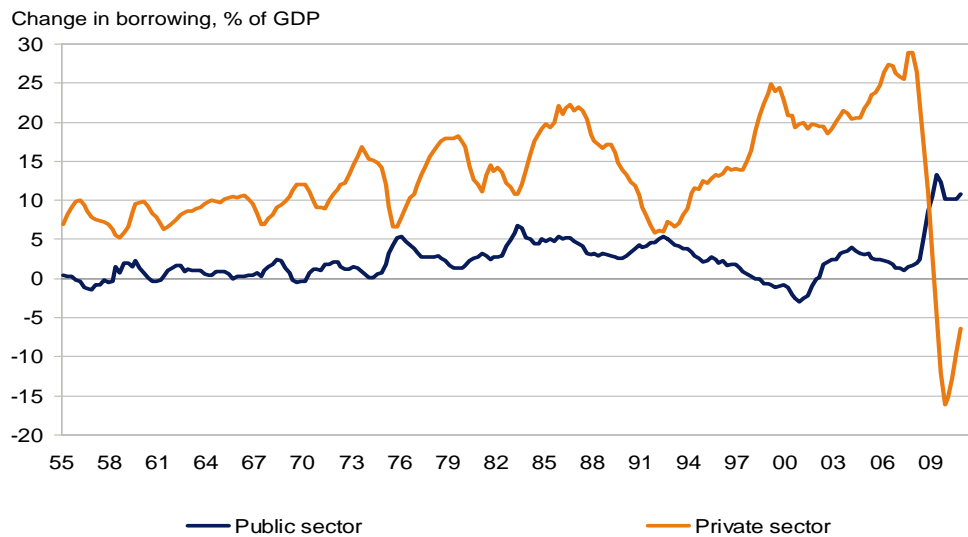
Source: Thomson Datastream, Schroders, 20 April 2011

G7 real long rate: G7 10-year government bond yield (GDP-weighted) adjusted for core CPI inflation. G7 real short rate: G7 3-month LIBOR rate (GDP-weighted) adjusted for core CPI inflation

...and weak demand for credit

The second explanation is that the overall demand for borrowing is low. To see this look at the US flow of funds data which shows that private demand for credit remains weak, the de-leveraging story discussed above (see chart 4). This means that the government is effectively the only borrower in town and consequently can pay relatively little. In practice, what we see is a banking sector facing little demand for funds from its corporate or household customers, finding it has excess reserves which are then invested in the Treasury market by default.

Chart 4: Borrowing by sector in the US: private demand remains weak



Source: Thomson Datastream, 20 April 2011.

Rising rates pose a threat, but it depends why they are going up

Whichever explanation you favour, the threat from this perspective is economic recovery brought about by an increase in demand for credit and tightening of monetary policy. Short rates would rise, pushing up bond yields and the government would find itself competing harder for funds. This is certainly true *ceteris paribus* and a reason why rates will probably not rise rapidly as growth returns. However, we should also recognise that not all things are equal and that economic recovery will also bring lower unemployment and benefit payments and stronger tax revenues, thus helping to cut the deficit. There will be some cyclical improvement in deficits as real rates rise.

The more dangerous situation is one where interest rates rise without any cyclical improvement. In other words, risk premiums increase as lenders begin to fear a default. This of course has been the story in Greece, Ireland and Portugal as investors gradually recognised that government finances were on an unsustainable path.

Could something similar happen in the US? Some investors have already acted to hedge portfolios for such a scenario and it remains difficult to see how the divide between the Republicans and Democrats can be bridged. Given the size of the structural budget deficit, cyclical improvement alone will not be sufficient and the solution will probably mean significant action on entitlement spending and taxes.

The politicians seem some way apart at this stage. However, they do agree on the need to cut borrowing. Moreover, the outcome really depends on the attitude of those who fund the US government. If creditors keep funding at close to current yields the show can go on.

Recently, of course the US government has been largely funded by Quantitative Easing with the Fed effectively printing money to buy Treasuries. However, although significant this has always been seen as temporary and the more durable source of funding to the US comes from overseas, the counterpart to the current account deficit, particularly central banks in Asia and the Middle East.

He who pays the piper calls the tune

Around 30% of the US Treasury market is held by foreign central banks, if we just count those reserves held in custody at the Federal Reserve (see chart front page). This represents the "exorbitant privilege" of the US: due to its status as a reserve asset there is a natural demand for the dollar. For this reason it is difficult to see the pattern of rising risk aversion and increase in default premiums which have undermined countries in peripheral Europe. Consequently, the US should have considerably more leeway to put its fiscal house in order and retain its AAA rating.

Of course, this could change but it would require countries like China to alter their foreign exchange policy and stop pegging the Chinese Yuan (CNY) to the dollar. We do not see this happening in the near term, beyond the minor adjustments being made by the authorities at present to allow the CNY to appreciate.

Overall, while S&P might make the headlines it is clear that the real power over US Treasury yields lies with the central banks and particularly the biggest holder of foreign exchange reserves, China.

EUROZONE

Portugal has thrown in the towel and has requested its own bail-out package.

Eurozone: Staring into the abyss

Portugal has gone as far as it can without resorting to a bail-out. The resignation of Jose Socrates as prime minister was followed by a plea for international aid, as contagion from Greece and Ireland engulfed the troubled state.

The root cause of the loss in confidence in Portugal is the economy's growth deficit – the inability to generate enough growth to stabilise and even reduce debt relative to national income. Perhaps this is more honourable than Greece's budgetary discrepancies or Ireland's credit and construction binge, however, a growth deficit is also more difficult to rectify. There are no quick fixes for Portugal and short of restructuring its debt; it is difficult to see how or when market dynamics will be compatible with Portugal's public finances returning to a self sustaining path.

Then there were three

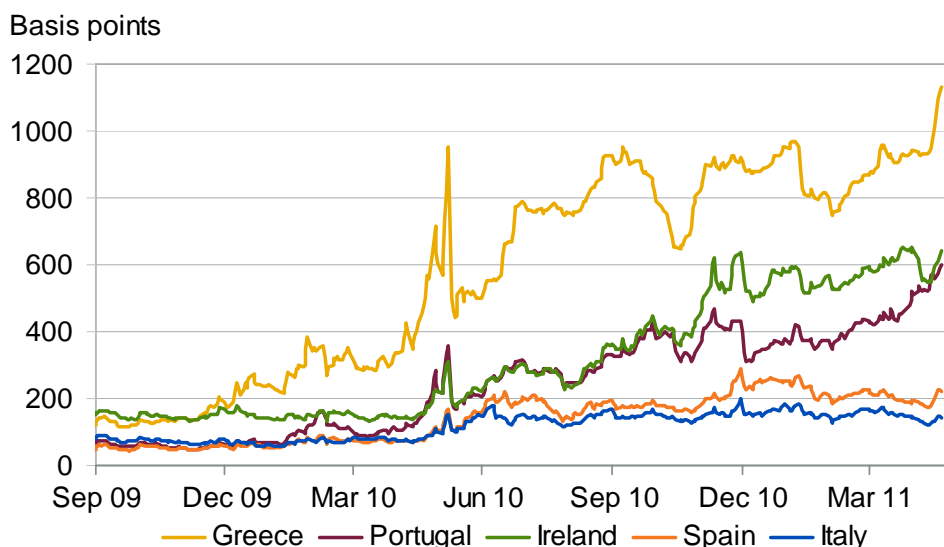
Markets and investors were surprised last month when the news broke of Portugal's surrender to market pressures. Though it was widely seen as an inevitable outcome, most had expected Portugal to wait until after European leaders had finalised the expansion of the European Financial Stability Fund (EFSF).

As we have highlighted in last month's *Economic & Strategy Viewpoint*, the European Council failed to finalise the details of the expansion of the EFSF and have instead postponed the decision until the next meeting in June. The hope from EU leaders was to have the reinforced fund in place before Portugal is tackled. Not because the needs of Portugal would be too much for the fund, but just in case the crisis spreads quickly to Spain – which would be too great a burden for the EFSF to bear.

Peripheral government bond spreads over Bunds are rising once again...

The spreads between peripheral government bond yields and German bunds (the closest thing to risk free long-term interest rates) have continued to rise in reaction to recent events (chart 5). The spread for Portuguese bonds quickly surpassed the levels that Ireland and Greece saw before they requested aid.

Chart 5: 10-year government bond yield spreads over German Bunds



Source: Thompson Datastream, Schroders. Updated 21 April 2011.

...with the ECB raising rates not helping matters.

Pressure is mounting on all the peripherals. Not only have spreads over Bund yields been rising, but the underlying risk free rate has been too, exacerbating the crisis. The European Central Bank (ECB) increased its main refinancing rate from 1.00% to 1.25% this month, and it is expected to be the first of a series that will eventually normalise interest rates. Though household demand for credit remains low in peripheral Europe, most homeowners' mortgages are on a floating rate. For example, approximately 90% of Portuguese households have floating rate mortgages priced off EURIBOR.

The strength of the economic recovery in Northern Europe, and expectations of further rate rises have prompted a rise in Bund yields, which as shown in chart 6, have risen by approximately 220 basis points since the summer of last year. In the end, it was the rise in the risk free rate that pushed Portugal over the edge.

Chart 6: 10-year German Bund yield (%)



Source: Thompson Datastream, Schroders. Updated 21 April 2011.

Default fears return

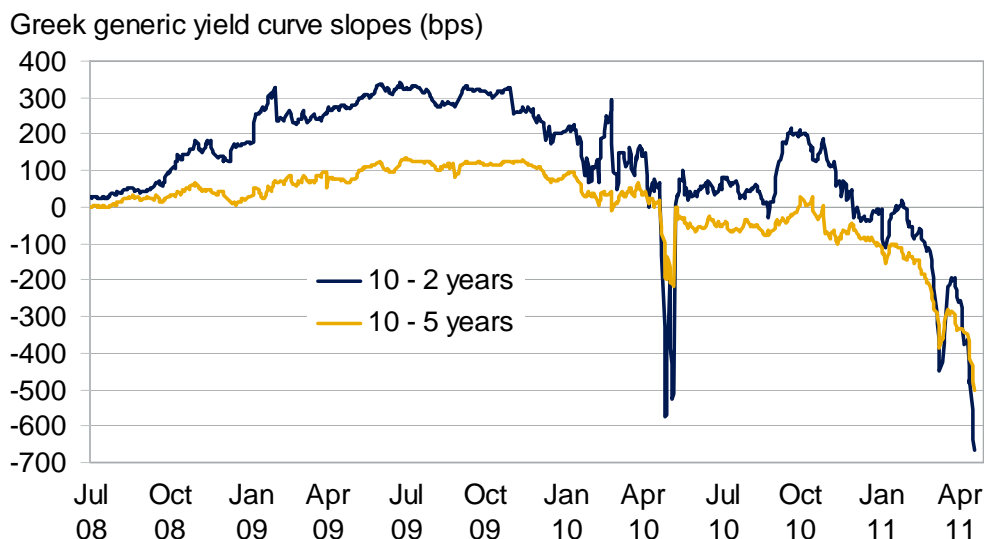
Meanwhile, fears of a Greek default have returned...

Up until very recently, there had been a breakdown in the correlation between *Portugal's yield spread, and those for Spain and Italy*. It had seemed that investors were beginning to distinguish between the most troubled peripheral states, and those with more sound fundamentals. Indeed, even the Euro was making gains at the same time as Portugal was requesting help. However as chart 5 showed earlier, the positive relationship quickly resumed following comments from German officials that a Greek debt restructuring was becoming more palatable. Instantly, fear of the impact of restructuring swept through markets, with the Spanish 10-year bond yield spread over bunds rising by 28.5 basis points - the biggest single day rise on record.¹

We, along with many, believe that Greece will eventually have to restructure its enormous debt mountain. However, it appears that most investors had not been prepared for such comments out of Berlin, and so soon.

Yields have now risen sharply on Greek debt, but particularly for debt that is due to mature in the next two to six years. As a result, the Greek sovereign debt yield curve has once again inverted - a classic sign of default risk (see chart 7 on next page).

¹ Close on Friday 15th of April 2011.

Chart 7: Restructuring fears return

Source: Thompson Datastream. Updated 21 April 2011.

...though we think it is unlikely in the near term.

Though we have warned about the risk of sovereign debt restructuring in Europe for most of the year, we continue to hold the view that Greece is unlikely to actually restructure its debt in the near term. There are three crucial factors supporting our view:

1. Greek deficit: Even when excluding interest payments on existing debt, Greece is still heavily reliant on external funding in order to make up the shortfall between government spending and tax revenues. Until Greece begins to run a surplus on its primary account, the economy will continue to rely on external funding.

2. Inability to discriminate: With the exception of the International Monetary Fund (IMF) contribution to the bail-out (which holds seniority status), the rest of the loans from European Union partners and all of the Greek bonds the ECB holds would have to be restructured along with the debt held by private investors. Therefore, any restructuring would likely lead to the end of any EU support for Greece, as EU voters would simply not tolerate further loans being made once losses have been incurred. The introduction of the European Stability Mechanism (ESM) from mid-2013 will provide EU loans with new seniority over private investors. However, even then, the existing loans would have to be rolled over into the ESM, which is not automatic in mid-2013.

3. Wider implications: A Greek default would not only probably end support to Greece, but also any other peripheral country. Negative sentiment is mounting across Europe and this momentum is helping nationalist Euro-sceptic political parties gain support. The Finnish parliamentary election this month provides a perfect example as the True Finn party made substantial gains, and may even enter into a coalition government.

The gains from a restructuring in the near term are obvious - a substantial reduction in the cost of servicing its debts, which would create a sustainable footing and may even in the long run save European taxpayers billions of Euros. However, given how poorly the costs and benefits of the bail-out have been communicated by EU leaders (especially in Germany), we cannot see such an argument persuading many voters.

A more likely outcome would be restructuring to take place post the introduction of the ESM, and once Greece is running a primary surplus on its fiscal balance sheet.

Can Portugal generate enough growth?

Amid political uncertainty, Portugal needs to raise more cash to guarantee meeting its June debt repayment.

Meanwhile, Portugal needs funding with approximately €7bn worth of debt due for repayment on the 15th of June. Portuguese officials suggest that they should have most, if not all of the funding required to make good on the repayment. However, there is a significant risk of a small shortfall in revenues and so the IMF, ECB and European Commission (also known as the Troika) are currently in Lisbon, preparing the ground for a bail-out package similar to that of Ireland.

The immediate risk for markets is the election due on the 5th of June (triggered by Socrates's resignation). Given Portuguese elections tend to yield hung-parliaments, it could take another 90 days before a government can be formed.

In any case, Portuguese civil servants are progressing negotiations on the working assumption that the major political parties will be willing to negotiate broad-based structural, fiscal and banking reforms with the Troika ahead of the election. Most of the parties agree with the pace of fiscal tightening that Socrates' government had planned, but they disagree on the mix of spending cuts and tax increases.

For us, the real challenge for Portugal is growth in the medium term. Along with the Portuguese Ministry of Finance and Central Bank, we expect Portugal to soon double dip back into recession, as public sector pay cuts and the increase in VAT take hold. However, once fiscal tightening comes to an end, how much growth can Portugal generate, and will it be enough to stabilise its debt position?

However, we believe a growth deficit is the real problem Portugal has.

Currently, Portugal aims to cut its public deficit to -4.6% for this year, to -3% for 2012, and -2% by 2013. The hope is that the economy continues to grow at a trend rate of 1% a year, and at least 1% inflation is generated. In our view, the assumption of 1% trend growth is optimistic. The OECD agrees. In its November World Economic Outlook (No. 88), the Paris based organisation published its forecast for potential growth for Portugal to be 0.5% for 2011.

Like most other Western economies, we should expect some downgrade to long-term growth, at least due to the lack of credit availability from the banking system. Portugal's banking system is thought to be relatively robust, though now suffering from a liquidity problem, mainly caused by the crisis in the sovereign debt market. However, the Central Bank of Portugal is forcing a number of Portugal's largest banks to reduce the size of their loan books, in the absence of additional capital being added to their balance sheets.

There has been some good news from stronger Portuguese exports...

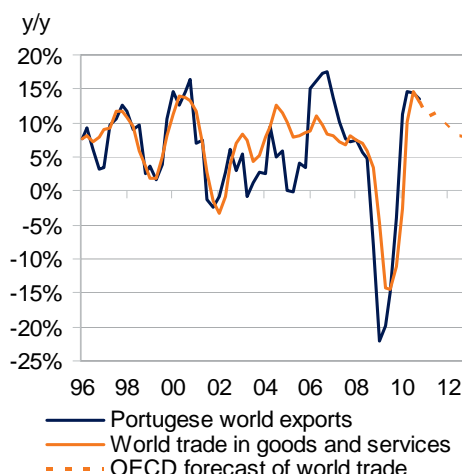
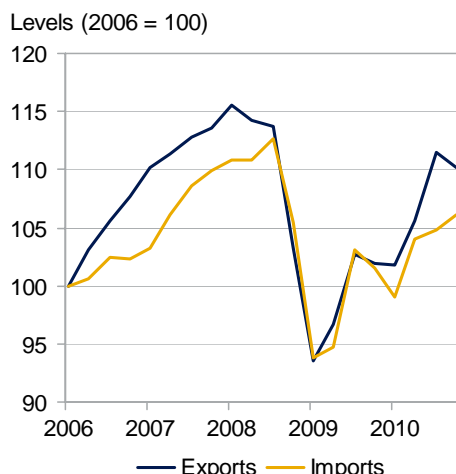
Where there has been good news is on the external side. Like the other peripheries, Portugal's real effective exchange rate - a measure of relative competitiveness - has been rising, albeit not as rapidly as Italy and Spain.

In spite of this, Portuguese officials have been buoyed by the recent strength of Portuguese exports relative to imports. Chart 8 shows how the level of real exports had outpaced imports before the financial crisis, and has been doing so again. Strong growth in former Portuguese colonies has been a blessing, although with global trade expected to slow this year and next, Portuguese real export growth should also moderate, reducing the contribution from net trade to GDP growth (chart 9). Moreover, Spain remains Portugal's biggest trading partner, with roughly 30% of its exports heading to its Iberian neighbour. This makes Portugal heavily exposed to the faltering Spanish economy.

Chart 8: Portuguese real exports & imports

Chart 9: Real exports vs. world trade growth

...though this is likely to be short lived as global trade growth is expected to moderate.



Source: Eurostat, OECD. Updated: 20 April 2011.

Austerity measures will be very painful in the short-term, but they will have to be larger, and even more painful if they are carried out without the implementation of structural reforms. If structural reforms enhance trend growth in the long-term, then Portugal may be able to reduce the amount of austerity it has to carry out.

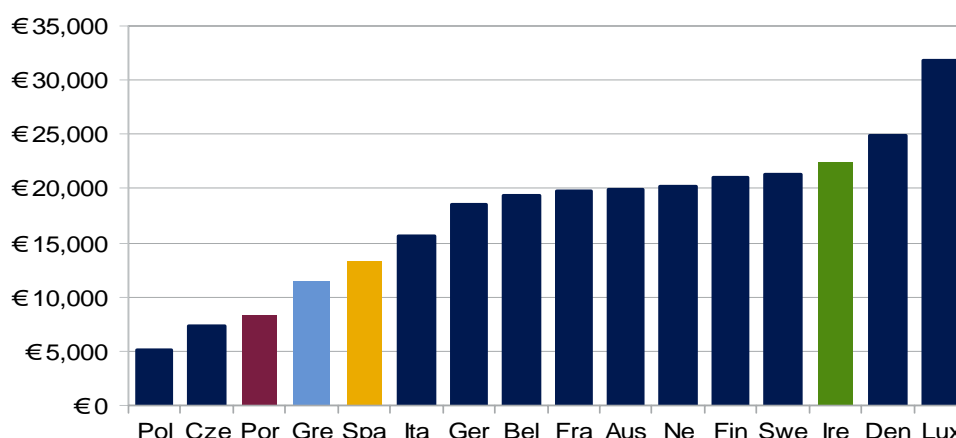
Structural impediments severe

Structural reforms will be key, and though Portugal is becoming less competitive externally, it continues to have relatively cheap labour...

The first priority for structural reforms must be the Portuguese labour market. The new authorities must ensure a step change is made in reducing the cost of hiring and firing workers. Wage bargaining continues to take place centrally with trade unions, despite unionisation being relatively low, while the relatively expensive and over-staffed public sector continues to crowd out the private sector.

Despite the recent deterioration in Portugal's external competitiveness as measured by the real effective exchange rate (mentioned above), as capital is now more mobile, it is worth comparing just the nominal cost of labour. Portuguese workers remain significantly cheaper than most of their European counterparts. Median annual pay is less than half of that in Germany and a little over a third of the cost of the median earner in Ireland (see chart 10 on next page).

Chart 10: Median annual pay (2009)

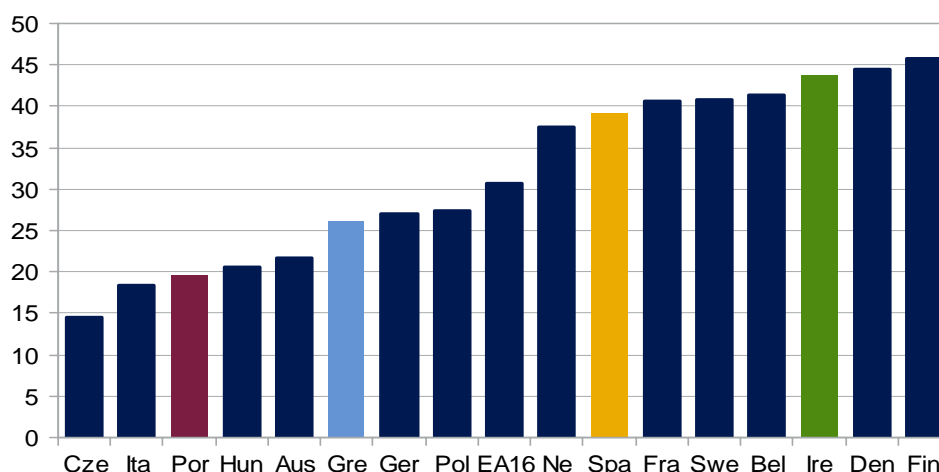


Source: Eurostat. Updated 21 April 2011.

...though this is largely due to poor productivity, and a legacy of poor education standards.

One could blame Portugal's poor productivity growth for pay levels continuing to be low. This is a fair argument. Portugal's labour force is still being held back by poor education standards, largely the legacy of the Salazar reign which came to an end in the late 1960s. Though younger generations are now raising participation rates in tertiary education, the older generation have typically been restricted to specialising in low value-added manufacturing - sectors that have lost out to Emerging Asia's ability to be even cheaper (see chart 11).

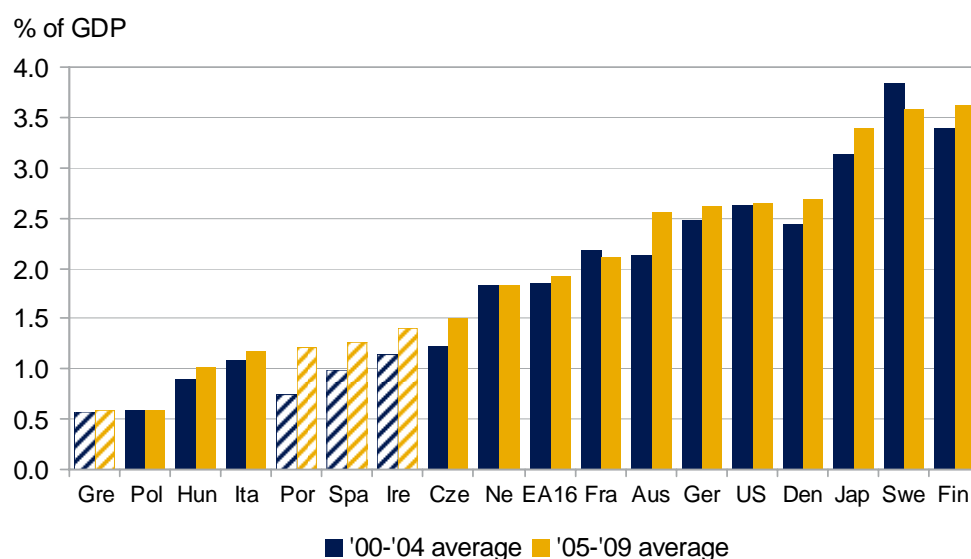
Chart 11: Proportion of 30-34 year olds who have attained tertiary education (2004-2009 average)



Source: Eurostat, OECD. Updated: 20 April 2011.

Nevertheless, the younger generation is finding success in moving up the value-added chain. One of the benefits of adopting the Euro is the currency stability that the domestic population enjoys, but also the stability that foreign corporation can also take advantage of. This has helped increase foreign direct investment in Portugal. As a result, investment in research and development (R&D) has risen sharply. R&D investment intensity (measured as R&D investment as a % of GDP) has risen by 70% in the four years up to 2009, compared with the previous four years. Though absolute R&D intensity remains low, Portugal has outperformed its European competitors in recent years (see chart 12 on next page).

Chart 12: Research & development investment intensity



Source: Eurostat. Updated 21 April 2011.

Not repeating past mistakes

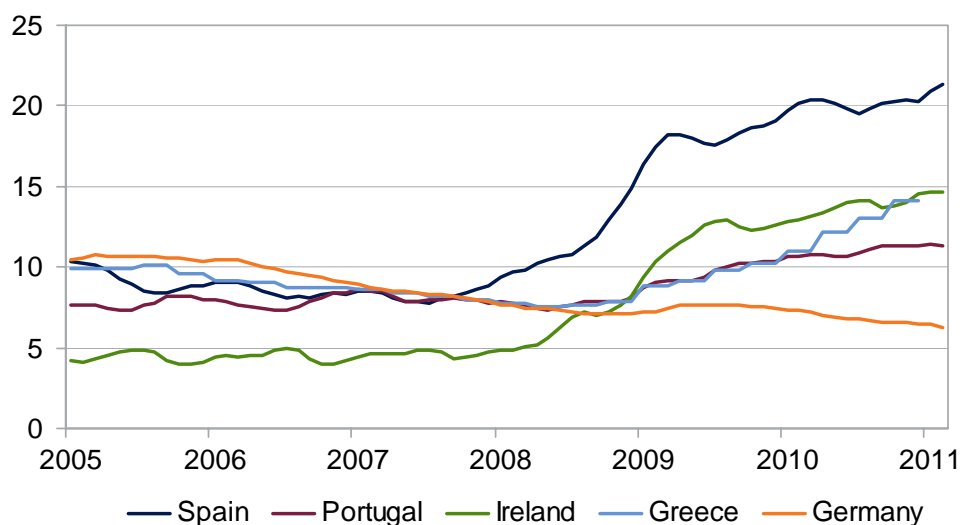
Portugal is staring into the abyss, and there is a risk it finds itself heading towards default and obscurity.

For Portugal's austerity programme to be successful, a credible and detailed multi-year plan must be presented to investors. The biggest factor behind the UK's success in winning back investor confidence was the 2010 Budget and Comprehensive Spending Review, where every tax increase and headline spending cut between then and 2015 was announced. Portugal must move away from annual budgets only being passed through parliament from year to year with the thanks of political deals being done.

The major positive for Portugal is the support of the population for fixing the nation's public finances. Having been through two previous IMF programmes, the Portuguese people understand what has to be done. However, at the same time, they expect to see the positive results that are being promised once austerity ends. The fear for investors is, like Greece, Portuguese officials make the mistake of assuming the cost of borrowing for the government will fall back to pre-crisis levels. Such an assumption could be dangerous as Portugal does not have the advantages of the US discussed in the global section. If yields stay elevated, then the scale of fiscal austerity must be greater to compensate. Moreover, there is the issue over growth discussed earlier.

With unemployment rates still very high (see chart 13 on next page), as austerity measures bite and the economy falls back into recession, if the government is forced to admit that even more austerity is needed, then the population could lose confidence in the Troika - and begin to favour default.

Chart 13: Unemployment rates (%)



Source: Thompson Datastream. Updated 21 April 2011.

Finally, the new government must take care not to repeat the mistakes of Salazar: placing greater priority on austerity than on education, which in the past, eventually led to Portugal becoming one of the poorest countries of Western Europe. Structural reforms must go hand in hand with austerity measures.

Portugal is staring into the abyss, and there is a real risk it finds itself repeating past mistakes and following Greece along a path towards restructuring.

I. Forecast summary (March 2011 forecasts)

Real GDP

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	2.9	3.3	2.9	3.2	3.3
UK	4.1	1.3	1.8	1.8	1.6	2.2
Eurozone	23.5	1.7	1.5	1.7	1.7	1.7
Japan	9.5	4.0	0.8	0.3	2.4	2.7
Australia	1.9	2.8	3.2	2.7	3.5	3.8
OECD	65.4	2.5	2.2	2.0	2.4	2.6
China	9.1	10.4	9.0	9.3	8.5	8.9
Emerging*	34.6	7.6	6.0	6.3	5.5	6.2
World	100.0	4.3	3.5	3.5	3.5	3.8

Inflation CPI

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	1.6	1.7	2.7	1.1	2.1
UK	4.1	3.3	4.1	4.1	2.0	2.2
Eurozone	23.5	1.6	2.0	2.4	1.2	1.8
Japan	9.5	-0.7	-0.3	0.2	-0.2	0.2
Australia	1.9	2.9	3.0	3.1	3.0	2.8
OECD	65.4	1.4	1.7	2.3	1.1	1.7
China	9.1	3.3	3.2	4.6	3.0	3.7
Emerging*	34.6	5.2	7.0	5.9	5.5	5.2
World	100.0	2.7	3.5	3.6	2.6	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	0.50	0.47	1.75	1.90
UK	4.1	0.50	1.25	1.17	2.00	2.25
Eurozone	23.5	1.00	1.50	2.03	2.50	2.74
Japan	9.5	0.10	0.10	0.33	0.25	0.41
OECD	63.5	0.52	0.86	1.07	1.82	2.01

Market data as at

25/04/2011

Key variables

FX	Current	Dec-10	Dec-11	y/y%	Dec-12	y/y%
USD/ GBP	1.65	1.60	1.60	0.0	1.60	0.0
USD/ EUR	1.46	1.34	1.30	-3.0	1.25	-3.8
JPY/ USD	81.8	83.0	86.0	3.6	90.0	4.7
GBP/ EUR	0.88	0.84	0.81	-3.0	0.78	-3.8
Brent crude	123.4	87.2	111.1	27.4	108.1	-2.7
US output gap %GDP	-5.3	-6.4	-3.7		-2.4	
Unemploy. %	8.9	9.6	8.0		7.5	

Source: Schroders, Datastream, IMF, Consensus Economics, April 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

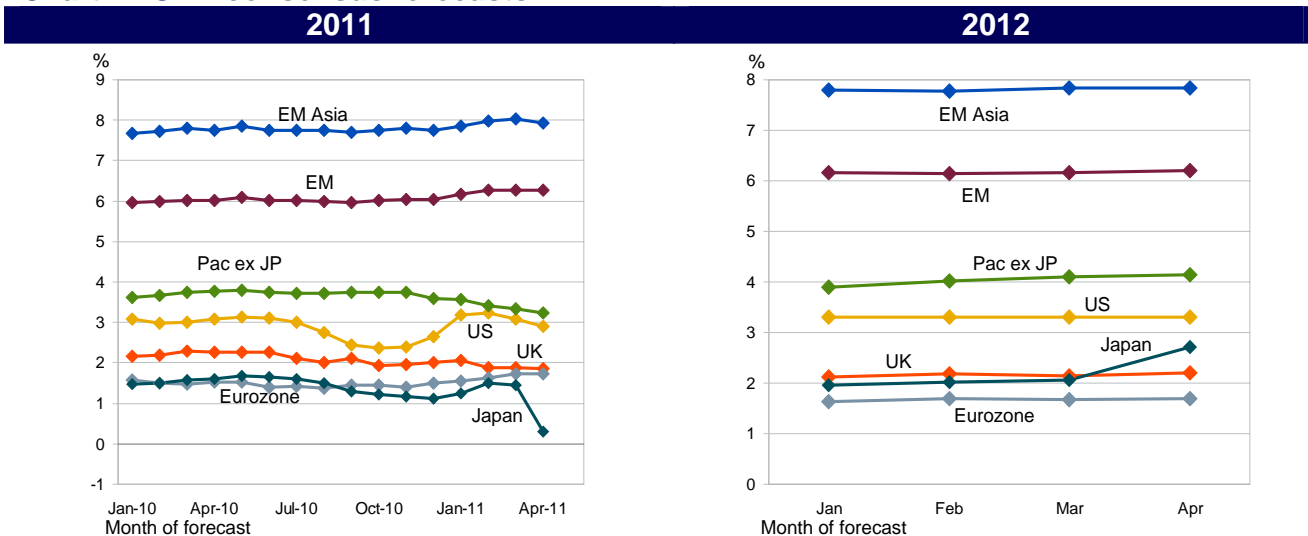
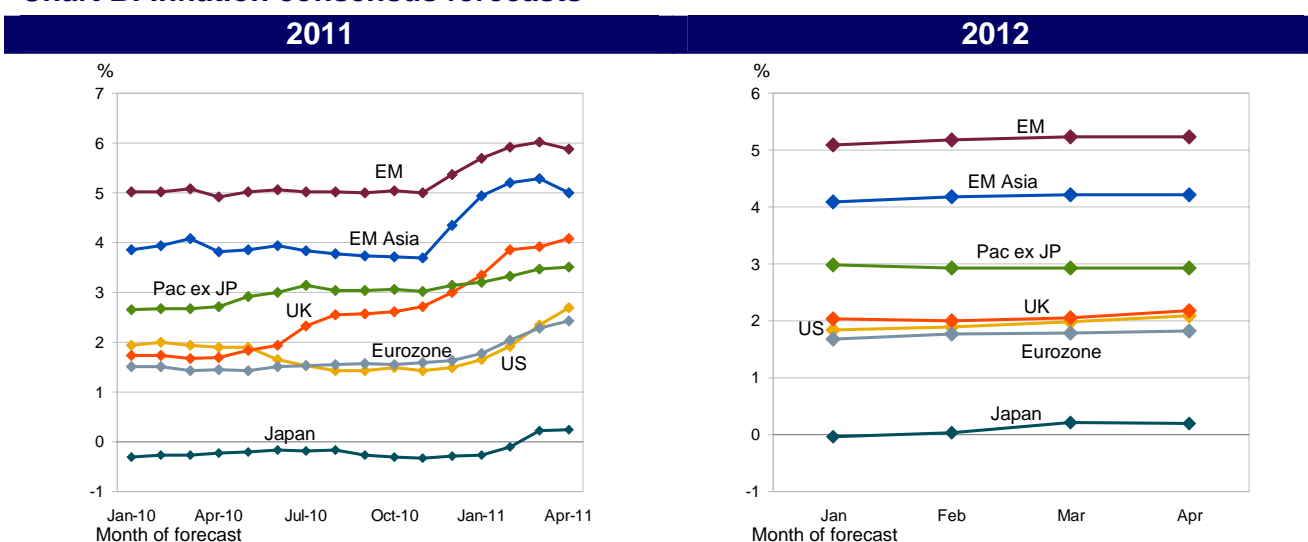


Chart B: Inflation consensus forecasts



Source: Consensus Economics (April 2011), 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, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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