

Schroders

Economic and Strategy Viewpoint

Keith Wade

Chief Economist and Strategist
(44-20)7658 6296

Azad Zangana

European Economist
(44-20)7658 2671

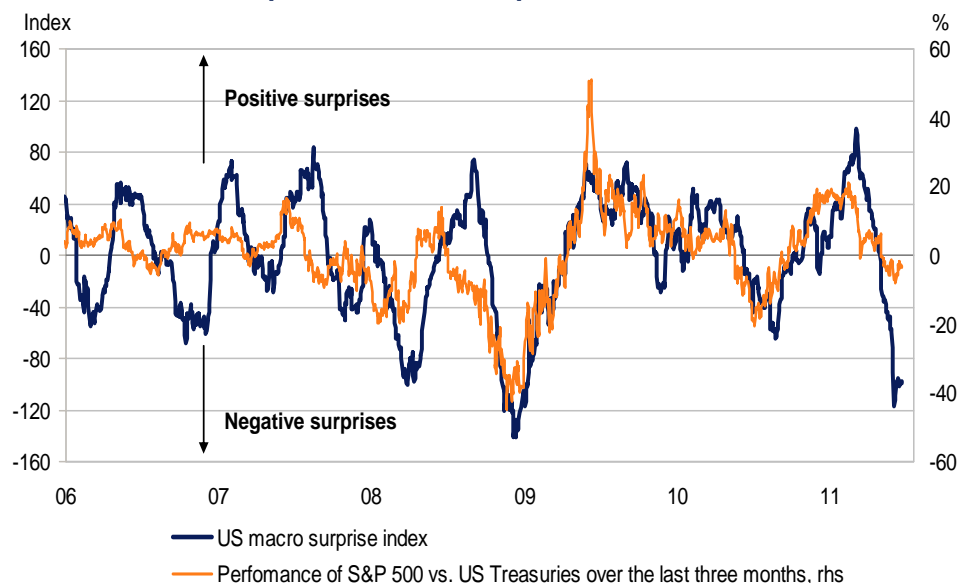
Global: The return of risk aversion

- **Weakness in the US, inflation in emerging markets and the return of Greek woes** have weighed on risky assets with equities experiencing a run of eight consecutive weekly declines. The economic news flow has been as negative as in 2008 relative to expectations. Markets appear to have been vulnerable with investors long risk assets prior to the deterioration.
- **On the macro front our baseline forecast is for a recovery in global activity in the second half of the year accompanied by low interest rates.** In other words a soft patch, not a double dip. Against a backdrop of ongoing corporate strength, we see a recovery in Japan combining with lower oil prices to support growth.
- **Such an outcome is favourable for risk assets, but is not without risks.** In the near term, growth worries dominate as markets fret over the recovery and the rescue of Greece. Further out inflation is more of a worry as, either by accident or design, it is likely that central banks keep policy too loose for too long allowing prices to accelerate.

Eurozone: The Greek crisis and a structural shift in European equity markets

- **The European sovereign debt crisis has escalated to a new phase.** Official institutions have finally come to terms with Greece as a solvency crisis rather than a short-term liquidity problem. This should pave the way for new thinking on how to resolve Greece once and for all. Meanwhile, we examine the recent performance of core equity markets versus peripheral and question whether the recent underperformance is likely to become a new trend.
- **Valuations suggest peripheral European equities are cheap relative to historical metrics, but if there has been a long-run change in earnings potential growth, these markets could follow Japan and remain cheap for many years to come.**
- **We conclude that core equity markets are likely to outperform peripheral markets over the medium to long-term, but that 'good' news on Greece in coming weeks would suggest that there will be a better entry point in the future.**

Chart: US macro surprises and market performance



Source: Citigroup, Bloomberg, Thomson Datastream, 23 June 2011



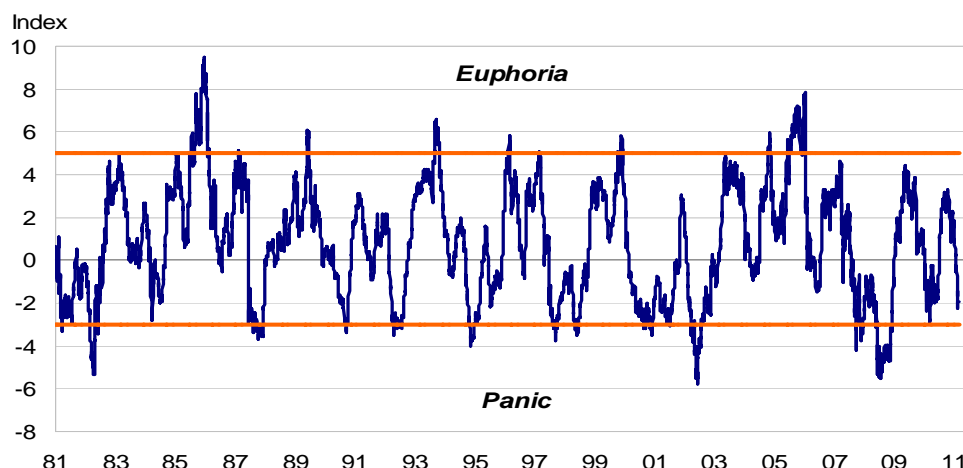
Global

Investors have moved into "risk off" mode

The return of risk aversion

Risk assets have suffered over the past three months with equities underperforming government bonds. Compared to the past 12 months this marks a reversal of performance after the improvement in equity markets in the second half of 2010 and early 2011. From this perspective, "risk on" strategies, which had worked in the year to March, have unwound in the second quarter. Risk appetite as measured by the Credit Suisse indicator, has dropped (chart 1).

Chart 1: Sharp fall in risk appetite

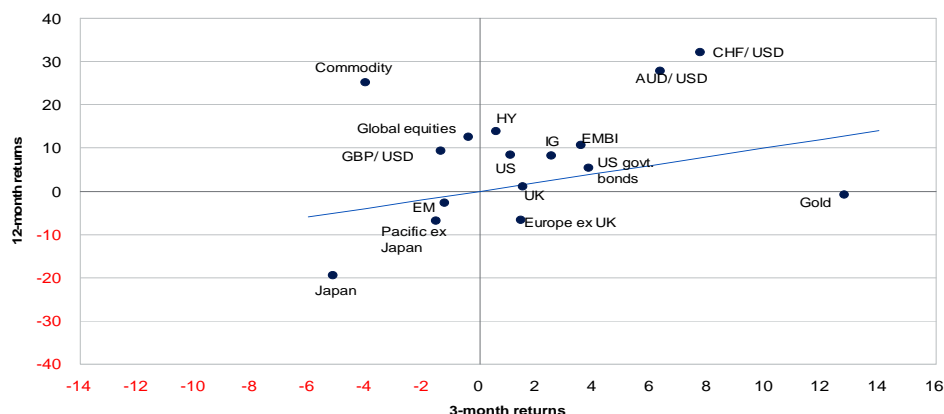


Source: Credit Suisse, 23 June 2011.

Consistent winners and losers

Those assets which have recorded positive returns on a 3 and 12 month basis can mainly be found in the bond space (US Treasuries and credit) whilst in equities, the more defensive US and UK markets and the telecoms and healthcare sectors have been the consistent outperformers relative to the market. By contrast, consistent losers over the period have been the equity markets of Japan and Pacific ex. Japan (i.e. developed Asia) and the emerging markets (particularly Latin America). Generally, it has still paid to be short the US dollar particularly against the Swiss Franc and Australian dollar (see chart 2).

Chart 2: Asset returns (3 and 12 months)



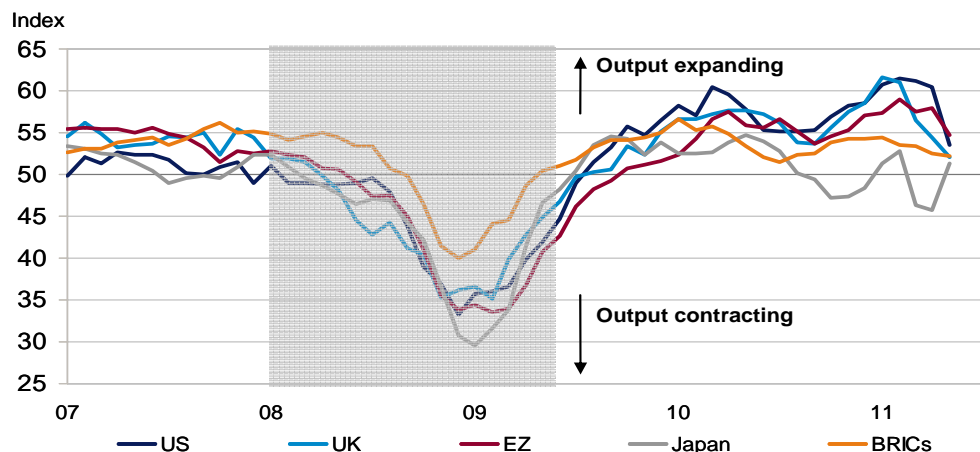
Note: MSCI regional equity total returns relative to world in local currency. Equities (MSCI World TR index), HY (Merrill Lynch US high yield TR index), IG (Merrill Lynch US investment grade TR index), EMBI (JP Morgan emerging market debt TR index), commodities (DJ UBS commodity TR index), gold (DJ UBS gold TR index) and govt bonds (US 10-year generic govt. bond TR index) relative to US cash. Source: Bloomberg, 22 June 2011.

Drivers

Weakness in the US, inflation in emerging markets and the return of Greek woes have been important drivers

There has been an important macro element to these moves. The past quarter has been characterised by increasing doubts about the recovery in economic activity following a rolling over in the Purchasing Managers Indices around the world (see chart 3), slower retail sales, another leg down in the US housing market and a faltering in US employment growth. Outside the US, inflation has been a concern in the emerging economies with the authorities tightening policy during the period.

Chart 3: Manufacturing Purchasing Managers' indices (PMIs) worldwide



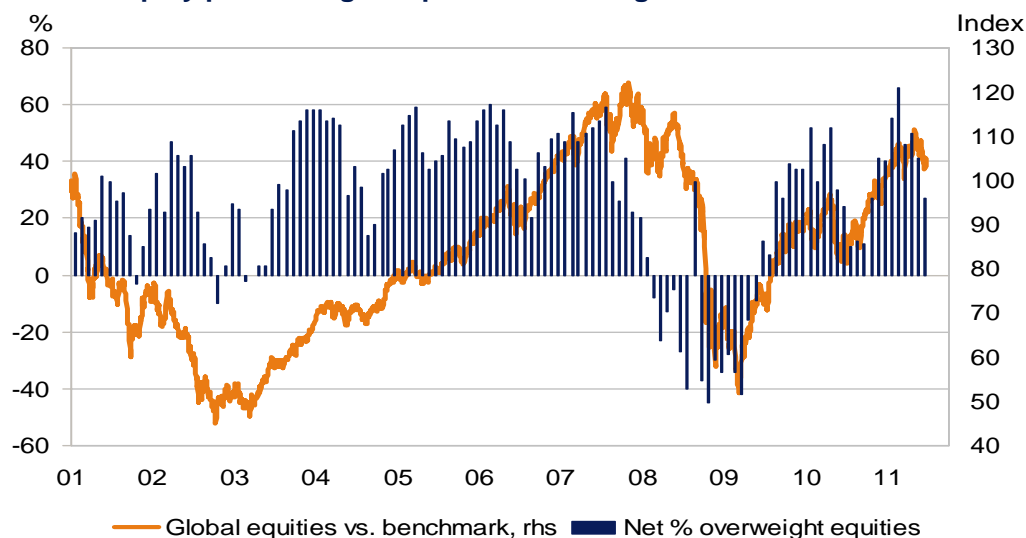
Shaded grey: US recession phase defined by the NBER (National Bureau of Economic Research)
 BRICs PMI consist of Brazil, China, India and Russia and are GDP-weighted.
 Source: Markit PMI, Schroders, 23 June 2011

The return of the sovereign debt crisis in the Eurozone has also increased risk aversion. After a period of relative calm, the focus returned to Greece when it became clear that the country would not be able to return to markets for funding in 2012 as required in the original IMF/ EU bail out. Against this backdrop investors have become wary of cyclical assets and have taken the opportunity to realise profits in risk assets.

It is not just the fall back in key activity indicators, but the fact that the flow of economic data has been considerably worse than expected. Surprise indices which capture the extent to which data releases miss expectations have plummeted in the US and are at levels last seen during the dark days of 2008 (chart on front page).

Negative surprises hit a market which was long equity

Although activity is stronger than three years ago and markets are in far better shape, the fall off in expectations has been similar. Furthermore, there is evidence that fund managers were becoming over optimistic on equities in the first quarter of the year. For example, the Bank of America Merrill Lynch survey of institutional investors registered a record overweight in equities in February, evidence that the asset class had become over owned (see chart 4 on next page).

Chart 4: Equity positioning and performance of global markets

Note: Performance of MSCI AC World relative to a benchmark, which consists of 60% equities, 30% global bonds (Merrill Lynch global broad market 1-5 years bond index) and 10% US cash. Base currency is USD. Source: Merrill Lynch Global Fund Manager Survey, Thomson Datastream, 24 June 2011

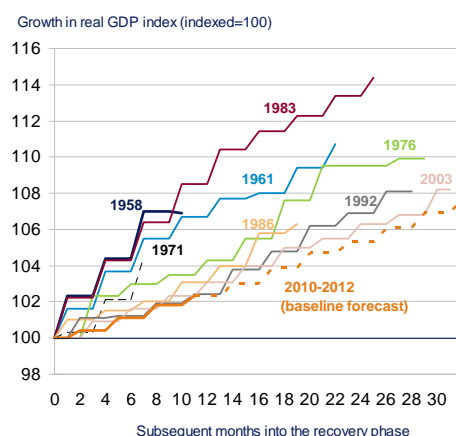
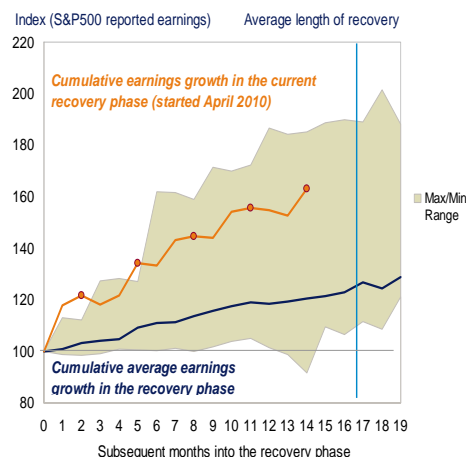
Near term outlook

Baseline forecast is for a soft patch, not double dip

After a period of disappointment on the macro front, we would look for a stabilisation in expectations in the coming quarter. From a fundamental perspective, we are of the view that the world economy has entered a soft patch, rather than being about to head into another recession. This represents our baseline view and is supported by signs that Japan is recovering after the earthquake and that supply chains will soon be restored so allowing manufacturing output to pick up. In addition, the recent fall back in oil prices means that the hit to global demand will gradually fade as we move through the rest of the year.

We also continue to highlight the very strong position of the corporate sector around the world where profits and cash flow have risen significantly. The share of profits in GDP has risen considerably as a consequence. Cash flow has been strong and, in contrast to the rest of the economy, corporate sector balance sheets are in good shape. From a macro perspective this bodes well for corporate spending. Capex is already picking up around the world and we expect companies to gradually increase hiring in coming months. An increase in employment would help secure the recovery by supporting the consumer sector where households continue to de-leverage.

The divergence between the fortunes of the corporate sector and the economy as a whole is also an important theme within the equity market. Using our cyclical framework we can show that although the recovery in GDP has been weak by the standards of past recoveries, the upswing in corporate earnings has been robust (see charts 5a and b on next page). The recovery in earnings has underpinned the rise in equity markets.

Chart 5a: US GDP growth and the recovery phase**Chart 5b: Earnings growth in the recovery phase**

Source: Schroders, Thomson Datastream, 18 June 2011

Asset class implications

If our macro view is correct, we would look for a turn in the surprise index, and risk assets which rely on growth at this stage of the cycle to perform more strongly.

Profits are likely to slow, but the market appears to have priced this in

Our top down projections suggests that operating earnings for the S&P500 can grow by 9% this year and 7% next (see table 1). This is far slower than the rate recorded in 2010 and less than the consensus, however, we believe the profit share in GDP is now approaching a peak and against a backdrop of modest nominal GDP growth there are limits to the rate at which capital's share of national income can rise. Nonetheless on our forecasts, valuations are reasonable with the S&P on a prospective PE of 14x for 2011 and 13x for 2012. From this perspective the equity market is pricing in a slowdown.

Table 1: Top down US profits and EPS forecasts

US	2009	2010	2011	2012
Economic profits				
y/y%	-9.7	45.7	10.9	7.3
Non.fin. share % GDP	5.8	8.0	8.5	8.8
S&P 500 EPS				
Operating \$ (consensus)	\$57	\$84	\$91 (\$98)	\$98 (\$111.8)
y/y%	15	47	9	7
Reported \$	\$51	\$77	\$86	\$94
y/y%	243	52	11	9
S&P 500 PE market at:	1115.1	1257.64	1275	1275
<i>Based on operating EPS</i>	19.6	15.0	14.0	13.0
<i>Based on reported EPS</i>	21.9	16.3	14.9	13.6

24 June 2011

Source: S&P, Schroders

When combined with the views of our asset class specialists, we would see equities as being the highest returning asset class over the next 6 months on this outlook. High yield and investment grade bonds would come next, followed by government bonds and gold. Overall commodities would be expected to deliver modest returns.

Macro risks

In the current risk averse environment, investors will need some convincing on economic recovery as the macro risks remain high. We would divide these into short (up to one year) and medium term (the next 2 to 3 years).

Short-term – Double dip

We can identify four potential causes of a return to recession.

1. The dislocation from Japan could last longer and companies may decide to pull back from increasing capex and employment. Such an outcome would come through relatively rapidly, within say the next 3 months.
2. Alternatively, the downturn could be caused by a bust in the emerging markets where the pick up in inflation proves to be more of a problem than many expect such that central banks in the BRIC's have to engineer a more rapid slowdown in activity than many expect.
3. Third, would be a renewed pick up in commodity prices which would boost inflation and cut into consumer spending, resulting in weaker demand and lower output.
4. A default in Greece might also tip the Eurozone back into recession through its effects on the banking sector and confidence. Contagion from Greece to other members such as Portugal, Ireland, Spain and Italy could then escalate the crisis.

On balance we would see the short term risk of these outcomes as relatively low. For example, there is evidence that commodity prices are now stabilising and will help bring emerging market inflation under control.

On Greece there are grounds to believe that the banking sector can withstand a haircut and that contagion effects may be limited as much of the debt is in official hands. Nonetheless, Greece is still a wild card with multiple outcomes from a benign scenario where the country gains support and meets its obligations to the IMF and EU, to outright revolution and departure from the euro.

Furthermore, the world economy is more vulnerable today to being blown off course by an external shock as a result of the financial crisis and the structural headwinds on growth. In particular, the continuing headwind from de-leveraging will weigh on demand as households and governments rebuild their balance sheets. This was the conclusion of Reinhart and Rogoff's study of 800 years of financial crises.¹ And there is no reason to assume that this time will be different.

Consequently, any of the negative shocks listed above have the potential to push the world economy back into recession and curtail the recovery phase of the cycle. What particularly concerns investors is that the authorities lack the ammunition to counter such a downturn: interest rates are already close to zero and fiscal policy is having to contract given the high level of debt and deficits. Many fear that the "Bernanke put" has expired with the Fed showing little inclination to contemplate another round of quantitative easing (QE3).

Growth concerns dominate short term risks

Post financial crisis headwinds will restrain growth

The end of the Bernanke put?

¹ Reinhart and Rogoff. "This time is different: A panoramic view of eight centuries of financial crisis," NBER (National Bureau of Economic Research), April 2008.

Despite near term growth worries, investors fear higher inflation over the medium term

Medium term risks - High inflation

Whilst the near term risks are skewed to the downside on growth, further out they tip toward inflation. We have argued elsewhere that three factors support the idea that the future will be more inflationary than the past.² These are:

- Central bank bias and the risk of policy error. Deflation is seen as worse than inflation in central banking land, meaning that policymakers are more prepared to take risks with the latter, but not the former. In an environment where there is uncertainty about the size of the output gap and the long run impact of QE, it is not inconceivable that an error will be made with inflation surprising on the upside.
- The changing role of the emerging markets (EM). The role of the emerging economies has changed from a deflationary to inflationary force, with EM now driving commodity prices, for example.
- High debt. The pressure to sustain growth in an environment where governments are struggling to bring down debt is immense. Either through accident or design, policy may be kept too loose with inflationary consequences.

The conclusion from this is that there are a number of forces which point toward a more adverse trade-off between growth and inflation over the medium term.

Strategy

The overall message from this analysis is a cautiously positive one where risk assets have the potential to recover on a modest improvement in the macro backdrop. The risks though are skewed toward a more adverse outcome either through a double dip or, further out, higher inflation.

How investors should look to hedge these risks is not straightforward as they appear to point in different directions with deflationary worries in the short term being overtaken by inflation further out. For a double dip, investors would head out of equities and credit and back into high quality government bonds and safe haven currencies such as CHF and SGD. For an inflation scenario, commodities would come back to the fore. However, safe haven currencies may continue to perform well as investors look for solid fundamentals.

² See Webcast: the drivers of higher inflation and implications for markets. Schroders Talking Point, 22 March 2011.

Eurozone

New trends

As the crisis in Greece continues to rear its ugly head, we examine recent developments in European equity markets and consider if the latest movements can develop into more than fears around a credit event in peripheral Europe.

Greece: Bail-out version 2.0 on the way

In recent weeks investors have become more concerned over the possibility of an uncontrolled default by Greece as supernational organisations finally realised that Greece was no longer a liquidity problem, but a more serious solvency problem.

The latest bout of fears began with the International Monetary Fund (IMF) seeking a change in the timetable for Greece. Under the IMF's own rules, it is not allowed to lend to insolvent entities if its own capital is at risk. As things stand, Greece is still expected to return to the market in March 2012 to sell treasury bills, but eventually also to start issuing bonds once again. The hope was that as the state of public finances improves, international investors would return and drive down the market cost of borrowing for Greece.

With Greek government bond yields persisting at unsustainable levels, the IMF changed its approach by demanding a more long-term solution be agreed with European partners before it disburses any more funding to Greece. The next tranche of Greece's bailout (worth €12billion) was due to be dispatched in June, but was pushed back to July to allow for the new negotiations.

The IMF's demands presented a new opportunity for fiscal hawks and triggered the second round of political jostling over what to do about Greece. The German Ministry of Finance demanded the involvement of private sector investors in restructuring of Greek debt. The French have tried to temper talk of default and with the ECB sternly against anything that could cause a credit event, the debate rumbles on.

Meanwhile, pressure on Greece was ramped up by the Troika (IMF, European Commission and European Central Bank [ECB]) to accelerate austerity measures in order to secure a larger and longer-term bail-out. Greece has been making good progress in cutting public spending over the past year, but the poor state of the economy combined with its terrible tax collection regime has meant that tax revenues have significantly underperformed expectations.

This has put tremendous pressure on Prime Minister George Papandreaou who saw 3 members of his ruling PASOK party (Panhellenic Socialist Movement) in Greece quit the party (but not all the parliament). This substantially weakened Papandreaou's majority in parliament and after backtracking on plans to resign and install a grand-coalition, Panadreaou opted for a cabinet reshuffle, and called for a vote of confidence. The re-shuffle saw George Papaconstantinou lose his job as Minister of Finance, with long-time internal rival to Papandreaou – Evangelos Venizelos – brought in the hope that it will re-unite the PASOK party.

Officials finally understand that Greece is more than a liquidity problem...

...but the new demands by the Troika almost drives the Greek government to collapse.

As domestic problems were mounting, the Troika realised that the pressure it was placing on Greece was raising the risk of a collapse of the Greek government, which could have led to the worst possible outcome: an uncontrolled disorderly default. In recognising the domestic stress, the Troika clubbed together and made a commitment to provide additional long-term funding for Greece, with rumours suggesting funding sufficient to extend the bail-out period until the end of 2014. However, before the Troika would agree on the package, it hit the proverbial ball back into Greece's court. The Troika demanded that the Greek legislative pass the new €28 billion additional austerity package before any more funding is made available.

The Greek government managed to survive, and so Greece bail-out v2.0 should follow.

After three days of debate, Papandreaou won his vote of confidence late in the evening of the 21st of June. At the time of writing (29th of June), despite violent protests outside, the Greek legislative passed the austerity package. A collective sigh of relief swept through European markets.

Though most had predicted a victory for Papandreaou in his crucial votes, the risk of serious tail risk materialising was very real. The opposition who continues to protest against austerity measures (but curiously not against the notion of deficit reduction), can afford to be vocal as at the end of the day, they are aware that their credibility is badly damaged due to their previous mis-management of Greece's public finances. If they had actually had a real chance to return to power, they would have taken a more responsible approach, in the same way oppositions have behaved in Portugal in this year's election, or in Spain with the next election due within the next year. As for the dissenting Pasok members, in the end, they all pulled together, with the knowledge that failure would have been catastrophic. At the end of the day, "turkeys don't vote for Christmas".

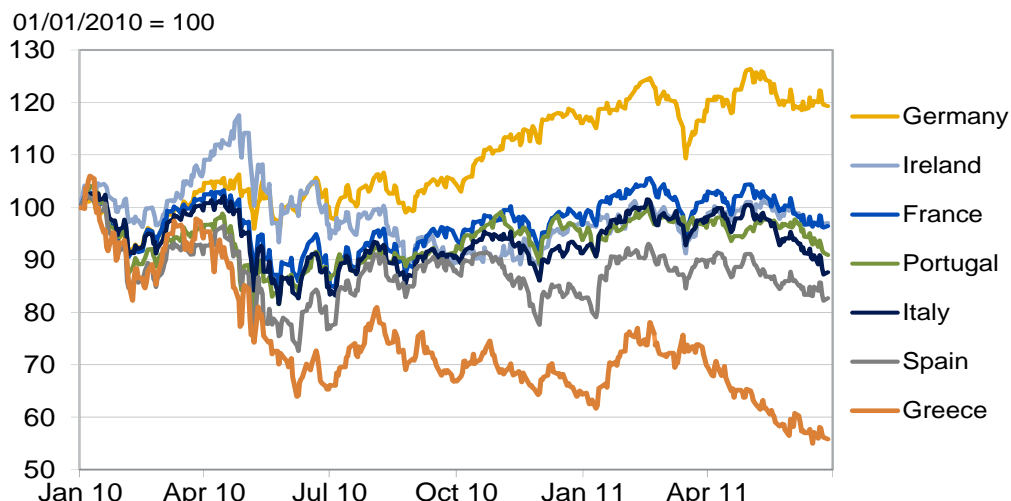
Looking ahead, Greece still has to pass a vote on its new privatisation plans and agree the new package with the Troika, which may still involve some kind of voluntary debt re-profiling. Nevertheless, this latest episode highlights the high degree of political uncertainty that is present, and the potential volatility that we should continue to expect.

European equity markets: New trends

The sovereign debt crisis in Europe has understandably had a big impact on European equity markets over the 18 months. Tough austerity measures in peripheral economies are causing a growing divergence in economic activity between the region and the core of Europe. Since the start of 2010, the Greek equity market has fallen by a huge 44%. Other peripheral markets have also suffered: Spain down 17% and Italy down 12% over the same period. By contrast, the German DAX index is up 19% (see chart 6 on next page).

Core equity markets have significantly outperformed peripheral equities over the past 18 months...

Chart 6: Equity market divergence

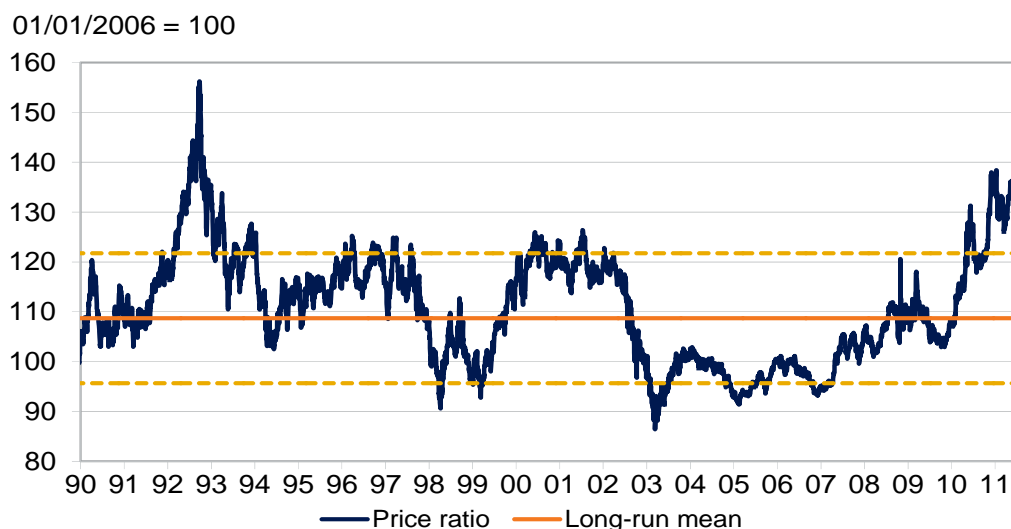


Source: Thompson Datastream Updated 28 June 2011. DAX30, CAC40, MIB, IBEX35, PSI general, Irish overall index, ATHEX composite.

Is this just a reaction to the crisis in Greece, or is there a more fundamental argument for this divergence to continue into the future? To examine this issue further, we have decided to limit our analysis to focusing on core and peripheral markets that have active and relatively liquid futures markets. This allows for practical use of this analysis through a long/short composite trade. Therefore from this point forward, any reference to core markets will be limited to Germany and France, and any reference to peripheral markets will be limited Spain and Italy.

Chart 7 shows the long-term price performance of being long core equities (DAX and CAC) versus the peripheral equities (IBEX and MIB). The trade appears to be mean reverting, and one could argue that with the price ratio now over one standard deviation away from the long-run average that investors should consider being long the periphery versus the core. However, we believe that the structural damage done to peripheral Europe caused by the credit crunch, but now being exacerbated by the sovereign debt crisis, could cause the start of a new long-term trend of the core outperforming the periphery.

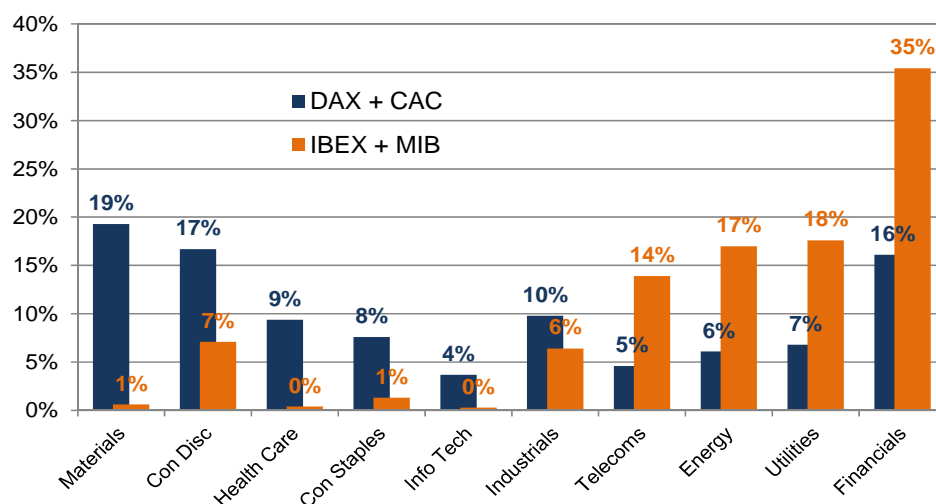
Chart 7: Long-term chart of core versus periphery



Source: Schroders. Updated 29 June 2011. Price ratio of DAX and CAC versus IBEX and MIB. Long-run mean and standard deviations calculated since 1 January 1988.

The sector composition of these indices has probably had a part to play in the underperformance of the periphery. When looking at the sector shares of the above trade, we see that the DAX and CAC jointly have a greater share of their market capitalisation value in the materials, consumer discretionary, healthcare, consumer staples sectors relative to the IBEX and MIB, whereas the IBEX and MIB have a larger share in the financials, utilities, energy and telecoms sectors when compared to the DAX and CAC (see chart 8).

Chart 8: Sector shares as % of total market capitalisation



Source: Schroders. Updated 29 June 2011.

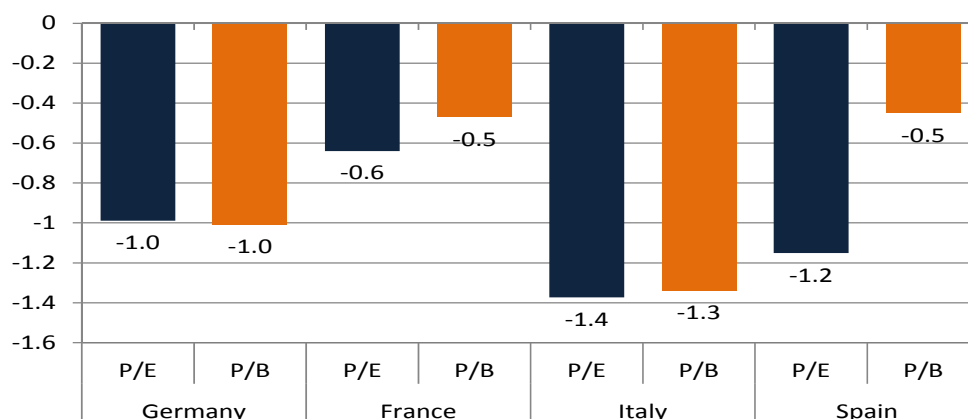
The relative presence of the financial sector in the core and periphery is particularly important. The structural hit from the credit crunch to the financial sector was enormous, and with the periphery having a larger share in the sector, it is bound to have contributed to the recent poor performance relative to core European equities.

Valuations

In terms of equity market valuations, all of the markets in question are between cheap and fair value. All four have below long-run average price-to-earnings (PE) and price-to-book (PB) ratios. Compared to their own history, the French CAC is the least attractive, with PE and PB ratios close to half a standard deviation below their long-run averages, to Italy's MIB, which has a PE and a PB that are more than 1.3 standard deviations below their long-run averages (see chart 9).

Peripheral European equities look more attractive than core using PE and PB valuations...

Chart 9: Normalised price to earnings (PE) and price to book (PB) ratios



Source: Thompson Datastream, Bloomberg, Schroders. Updated 29 June 2011.

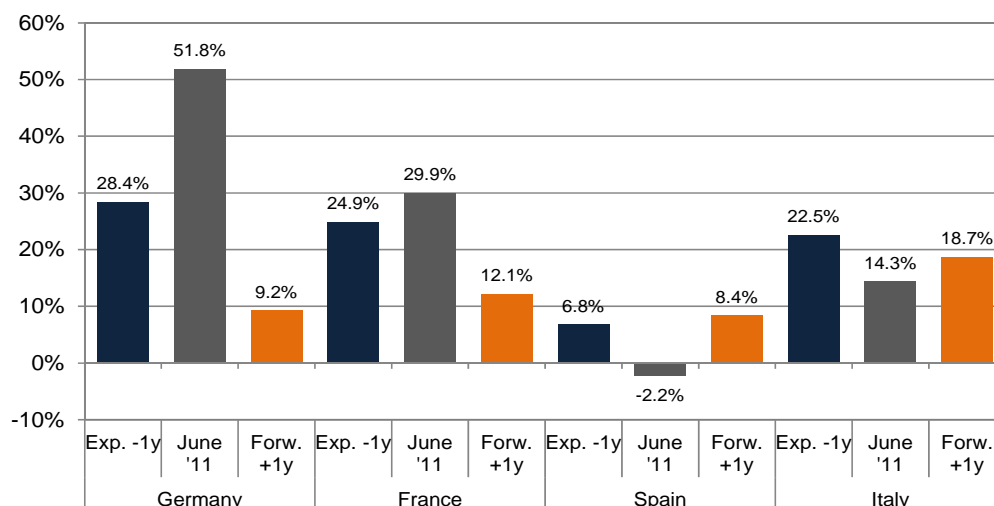
Generally, the periphery appears more attractive when comparing these valuation scores against their historical average. However, this all depends on whether we believe that the trend PE and PB will still hold. The earnings and book valuation components are based on current or historical valuations. However, the price component of the ratios includes the market's discount of future cash flows. Therefore, if there is a re-rating of potential growth for a company or market, then the adjustment will be seen in the price first.

A classic example of this is Japan following its financial crisis. For many years, Japanese equities have appeared to be cheap based on these metrics, partly because the long-run means included data from before the crisis.

The prospects for earnings growth are crucial looking forward. If we believe this is a new trend developing, then we should expect economists to begin to forecast lower trend GDP growth, and therefore investors to follow by expecting weaker earnings per share (EPS) growth. This process does not appear to have begun yet, which may present an opportunity. For example, 12 month forward EPS growth in June 2010 for Spain was 6.8%. Despite the actual outturn this month showing a -2.2% decline (using 12 month trailing EPS growth), analysts are even more optimistic for the coming 12 months – forecasting +8.4%. Similarly, the earnings surprise for Italy was negative and significant, and yet analysts are looking for a further acceleration (see chart 10).

Chart 10: Annual earnings per share (EPS) growth

...though core European earnings growth have surprised on the upside, while peripheral earnings growth has done the opposite.



Source: Thompson Datastream, IBES, Schroders. Updated 29 June 2011.

Comparison of 12 month forward EPS in June 2010, with the outturn in June 2011 (trailing 12 month EPS) and the forward 12 month EPS in June 2011.

As the above chart shows, the DAX index as a whole delivered a huge surprise in earnings growth (51.8% actual versus 28.4% expected), reflecting the much stronger than expected bounce back in the German economy.

Economic rationale: Greater divergence for longer

As we have highlighted in the past, our view is that the divergence between core Europe and peripheral Europe will be larger than consensus expectations, and is likely to persist for longer than many expect.

For example, we are forecasting real GDP growth in Germany to be 3.6% for this year against consensus expectations of 2.8%, and the German official forecast of 2.6%. On the downside, we are forecasting much lower growth for Spain in 2011 and 2012 relative to the consensus (see table 2 on next page).

Table 2: Growth expectations

We forecast the divergence in growth between core and periphery to be larger and last longer than consensus estimates...

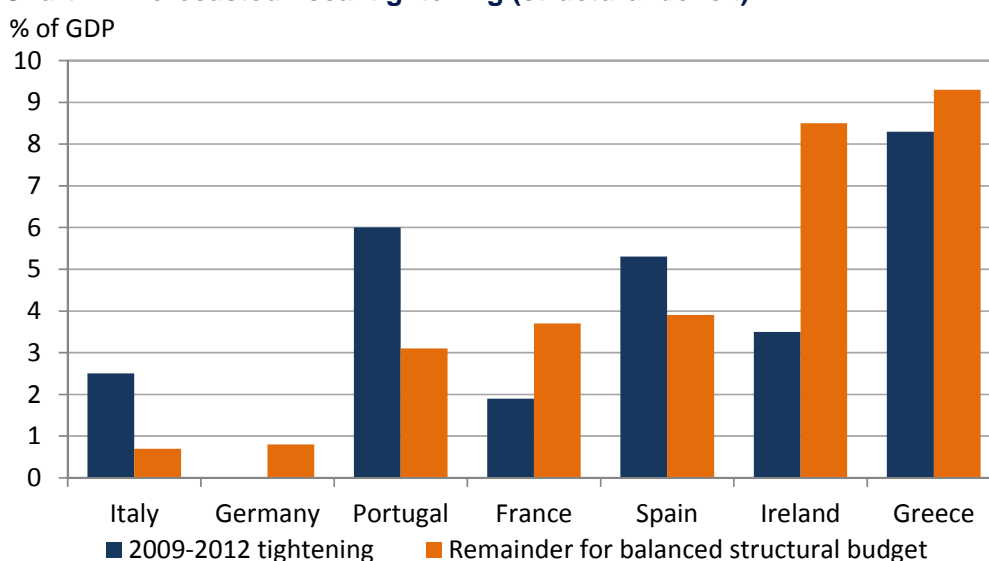
		2010	2011	2012
Germany	Official	3.6	2.6	1.9
	Consensus	3.5	2.8	1.9
	Schroders		3.6	2.1
France	Official	1.6	1.8	2.0
	Consensus	1.4	1.6	1.7
	Schroders		2.0	1.6
Italy	Official	1.3	1.0	1.3
	Consensus	1.2	1.0	1.1
	Schroders		0.8	1.3
Spain	Official	-0.1	0.8	1.5
	Consensus	-0.1	0.7	1.3
	Schroders		0.4	0.7

Source: European Commission, Consensus Economics (June publication), Schroders forecast. Updated: 29 June 2011. Official numbers are taken from latest Stability Programmes: Germany (07/04/2011), France (03/05/2011), Italy (13/04/2011) and Spain (29/04/2011).

As mentioned earlier, the key driver of the divergence in economic activity is the scale of the differing level of urgency in dealing with shortfalls in public finances. For example, excluding cyclical factors from the fiscal balance (and therefore looking at the structural deficit), the European Commission does not expect Germany to tighten fiscal policy at all between 2009 and out to 2012. Moreover, France is only expected to tighten policy by just under 2% of GDP over that time horizon. Conversely, Italy is expected to tighten policy by 2.5%, while Spain is expected to tighten by a mammoth total 5.3% of GDP (see chart 11).

Chart 11: Forecasted fiscal tightening (structural deficit)

...driven by not only differing needs for fiscal tightening...



Source: European Commission Spring 2011 forecast, Schroders. Updated 28 June 2011.

Of course, for some countries, the recent and forecasted fiscal tightening out to 2012 will not complete the correction required in order to stabilise public finances. Though Italy has relatively little more tightening to do (thanks to tremendous restraint through the downturn), Spain will still have a structural deficit of close to 4% of GDP.

In addition to the impact of the fiscal outlook for the core versus periphery trade, there are two additional factors to consider:

***...but also the fall
in the Euro, and
tightening
monetary policy***

1. The first is The weakness of the Euro is set to exacerbate the divergence within the Eurozone. The export orientated core economies have been and will continue to benefit disproportionately more from the currency devaluation than the import dependent periphery. This supports the structural divergence argument for growth and earnings that would suggest a long-term.

2. As there is little need for Germany in particular to tighten fiscal policy further and given the above regarding the Euro, there is growing pressure on the ECB to raise interest rates to combat the threat of future inflation. This is likely to hit peripheral European mortgage borrowers as the many of them rely on floating interest rates that tend to be priced using 1-year EURIBOR rates, where as core Europe tends to have long-term fixed rate mortgages. This is more a cyclical impact, but nevertheless, an important one.

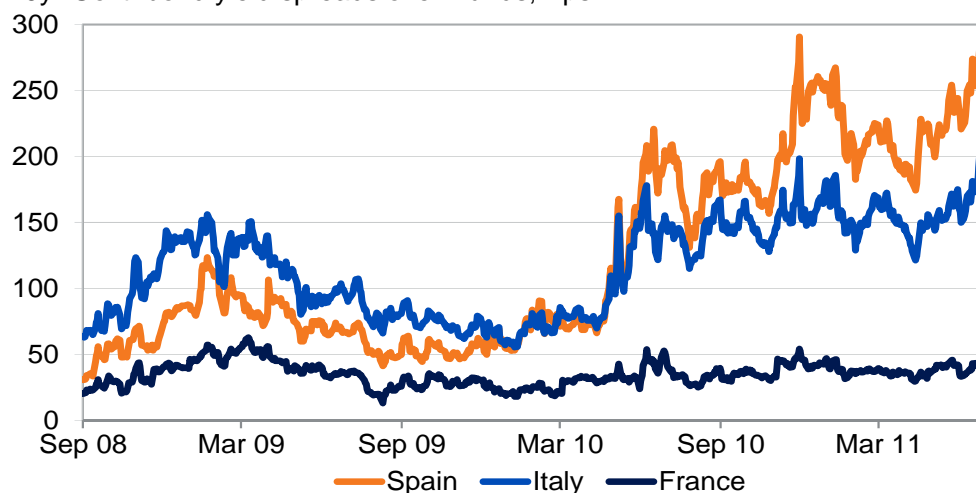
Finally, it is worth remembering that higher government bond yields in the periphery have a negative impact on these economies and equity markets through the risk premium that is added to the cost of borrowing for companies. In turn, this makes the cost of borrowing to invest more expensive but also the cost of refinancing existing debt higher. This should therefore reduce growth given the same quantity of capital financed through markets.

Some companies will be effected by more than others. For example, a well diversified international company could easily see the yield on its corporate paper/credit fall below that of its supposedly risk free sovereign.

In any case, it is difficult to assess whether the current spread of Spanish and Italian government bond yields relative to German Bunds are fair, but, it may be hasty to conclude that these markets have decoupled totally from events in Greece and Portugal (see chart 12). Indeed, some investors in Irish government bonds made that mistake in the middle of last year.

Chart 12: Higher risk premiums

10yr Govt. bond yield spreads over Bunds, Bps



Source: European Commission Spring 2011 forecast, Schroders. Updated 28 June 2011.

We expect core European equities to continue to outperform peripheral equities in the medium to long-term...

...however, 'good news' on Greece in the coming weeks may cause a pull back, before a better entry point appears

Looking ahead

As discussed in previous viewpoints, the peripheral countries have lost price competitiveness relative to the core as a result of several years of higher inflation. Euro devaluation helps Eurozone competitiveness but tends to favour the more export orientated core.

Therefore, in terms of the trade that has been discussed in this note, investors should not be concerned with the deviation from the long-run mean, and instead think about a new upward trend (see chart 13).

However in the near term, we could expect some pull back in the long core versus periphery trade, purely in reaction to Greece not blowing up this month, and the expected new bailout which should follow in July. We suggest there may be better entry points in the future.

Chart 13: Recent performance of core versus periphery

01/01/2006 = 100



Source: Schroders. Updated 28 June 2011. Price ratio of DAX and CAC versus IBEX and MIB. Long-run mean and standard deviations calculated since 1 January 1988.

I. Forecast summary

Real GDP

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	2.9	2.6	2.5	2.9	3.1
UK	4.1	1.4	1.5	1.6	1.9	2.1
Eurozone	23.5	1.7	1.9	2.0	1.6	1.7
Japan	9.5	4.0	0.0	-0.7	2.8	3.2
Australia	1.9	2.7	2.7	2.0	3.5	4.0
OECD	65.4	2.5	1.9	1.8	2.4	2.6
China	9.1	10.4	9.0	9.2	8.5	8.8
Emerging*	34.6	7.6	6.0	6.3	5.5	6.1
World	100.0	4.3	3.3	3.3	3.5	3.8

Inflation CPI

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	1.6	2.2	3.0	1.4	2.1
UK	4.1	3.3	4.4	4.3	3.1	2.5
Eurozone	23.5	1.6	2.4	2.6	1.7	1.9
Japan	9.5	-0.7	0.4	0.3	0.2	0.2
Australia	1.9	2.9	3.3	3.4	2.9	2.8
OECD	65.4	1.4	2.2	2.6	1.5	1.8
China	9.1	3.3	5.0	4.8	3.8	3.8
Emerging*	34.6	5.2	7.2	5.9	5.8	5.1
World	100.0	2.7	3.9	3.7	3.0	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	0.45	1.50	1.90
UK	4.1	0.50	0.50	0.97	1.50	1.43
Eurozone	23.5	1.00	1.75	1.78	2.75	2.02
Japan	9.5	0.10	0.10	0.33	0.20	0.38
OECD	63.5	0.52	0.80	0.96	1.77	1.68

Market data as at 27/06/2011

Key variables

FX	Current	Dec-10	Dec-11	y/y%	Dec-12	y/y%
USD/ GBP	1.60	1.60	1.68	5.0	1.60	-4.8
USD/ EUR	1.43	1.34	1.45	8.2	1.40	-3.4
JPY/ USD	80.9	83.0	81.0	-2.4	90.0	11.1
GBP/ EUR	0.89	0.84	0.86	3.1	0.88	1.4
Brent crude	105.8	87.2	113.3	30.0	110.1	-2.9
US output gap %GDP	-5.4	-6.4	-4.4		-3.1	
Unemploy. %	8.9	9.6	8.3		7.8	

Source: Schroders, Datastream, Consensus Economics, June 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

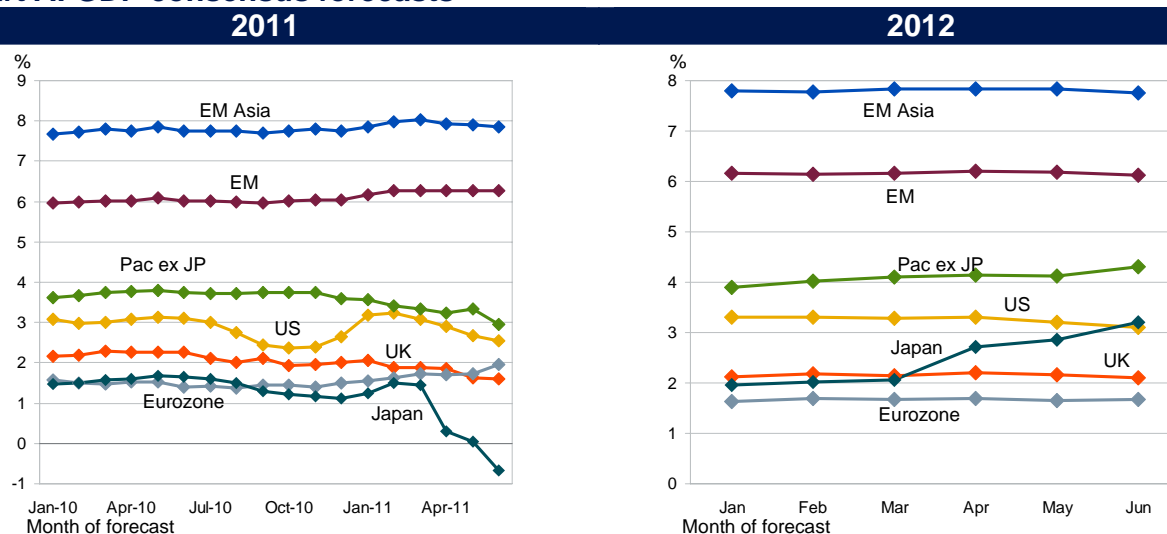
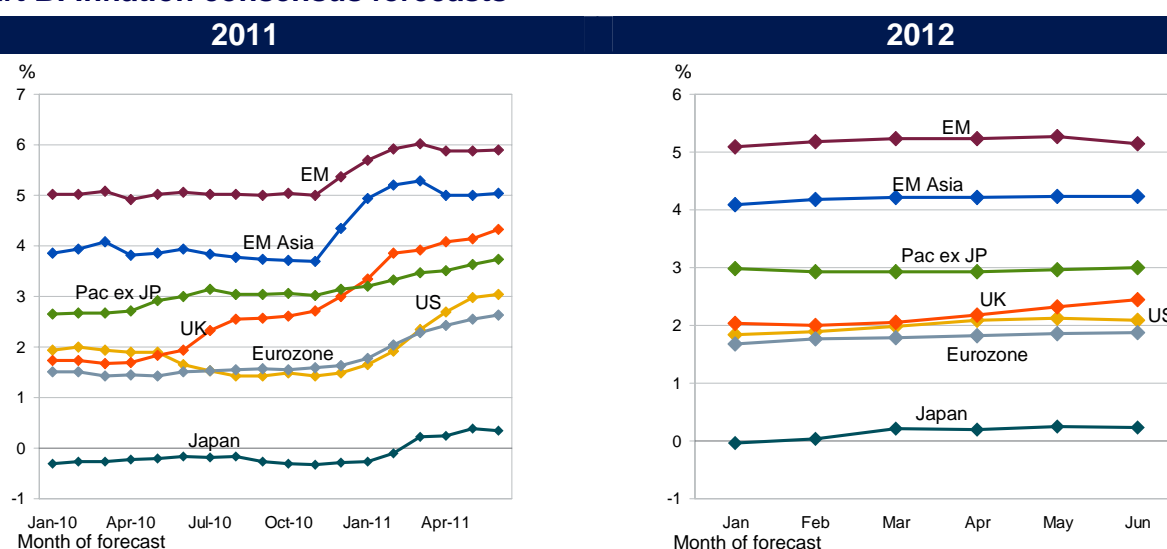


Chart B: Inflation consensus forecasts



Source: Consensus Economics (June 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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