Schroders

Economic Viewpoint

November 2007

Economics

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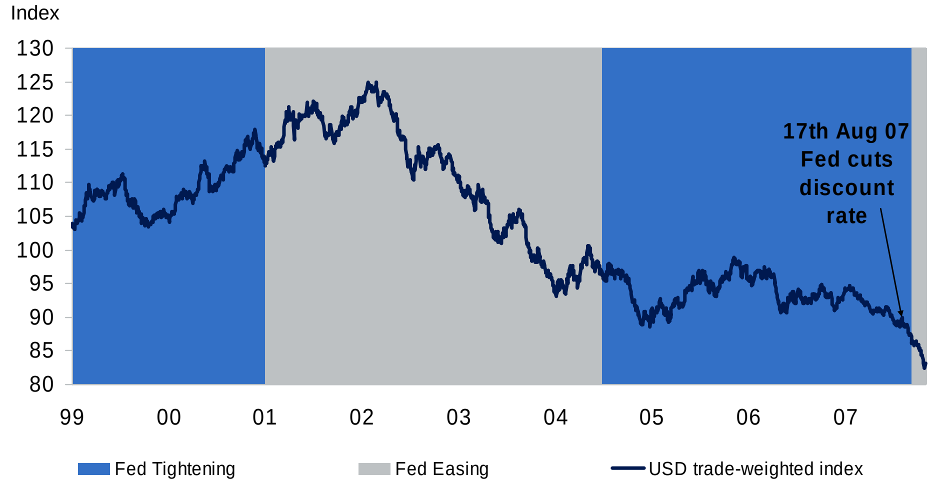
Global Views: Increasing headwinds to slow growth in 2008 (page 2)

- **We have cut our forecasts for global growth in 2008 to 2.9% from 3.1% with the OECD bearing the brunt of the adjustment. The rise in energy costs and the ongoing problems in credit markets mean that activity is likely to slow with the US flirting with recession around the turn of the year.**
- **In response, we now expect US interest rates to fall to 3.75% in the first quarter of next year. The Fed will need to balance higher headline inflation against weaker activity and potential problems in the banking sector. We believe that the slowdown in growth will result in a modest decline in core inflation allowing the Fed to "look through" the rise in commodity prices. Policy is also expected to ease in the Eurozone and UK in response to weaker activity and in the former, the strong Euro.**
- **Despite softer OECD demand, our forecasts for the Emerging Markets are little changed. Growth is still expected to moderate in 2008, but the easing of policy by the Fed is expected to be transmitted into looser conditions in Asia via a weaker US dollar and in some cases lower interest rates.**
- **This raises a danger of overheating in a region where inflation and money growth are already uncomfortably high. Given the current cyclical position it would be better if the US and Asia were 're-coupled' so that the slowdown in the former would cool inflationary pressures in the latter.**
- **The risks around our central view are skewed toward the downside for growth through either an outright crunch where lenders withdraw credit to firms and households, or a bout of stagflation. Neither is particularly appetising, but the latter may be worse from a market perspective as it would limit the ability of central banks to respond to lower growth for fear of losing credibility on their ability to control inflation.**

Forecast summary (page 11)

Chart of the month: Credit crunch takes its toll on the US dollar



Source: Thomson DataStream, Schroders

Recent growth figures have been solid, but headwinds are increasing

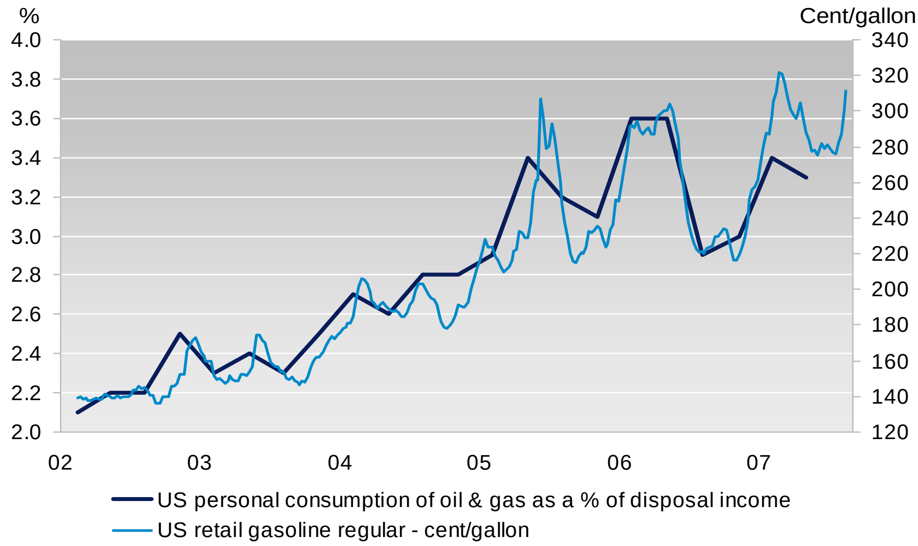
Higher energy costs and credit crunch to weigh on activity

Recent indicators show that US growth remained firm in the third quarter with the economy expanding by 4% in real terms. Yet, while this suggests resilience in the face of the credit crunch we have become more cautious about the outlook going forward as the headwinds on activity are increasing.

The housing market remains a drag on US activity and will continue to be so until the overhang of unsold homes is considerably reduced. However, this is not any worse than expected and there are two factors which lie behind the downgrade to global growth.

The first of these is the dramatic surge in the oil price which at the time of writing is approaching $100/ b compared to our previous assumption for an oil price of $70/ b in the fourth quarter. When combined with the buoyancy of food prices, higher oil prices will push up headline inflation higher around the world with US CPI inflation rising over 4% in coming months and remaining above 3% until the second half of next year. European inflation is less affected given the tax content in retail energy prices, but such increases in costs still act as a tax on consumer incomes thus dampening expenditure. To the extent that they are not passed on, profit margins will be reduced (chart 1).

Chart 1: Higher energy costs acts as a 'tax' on consumer incomes

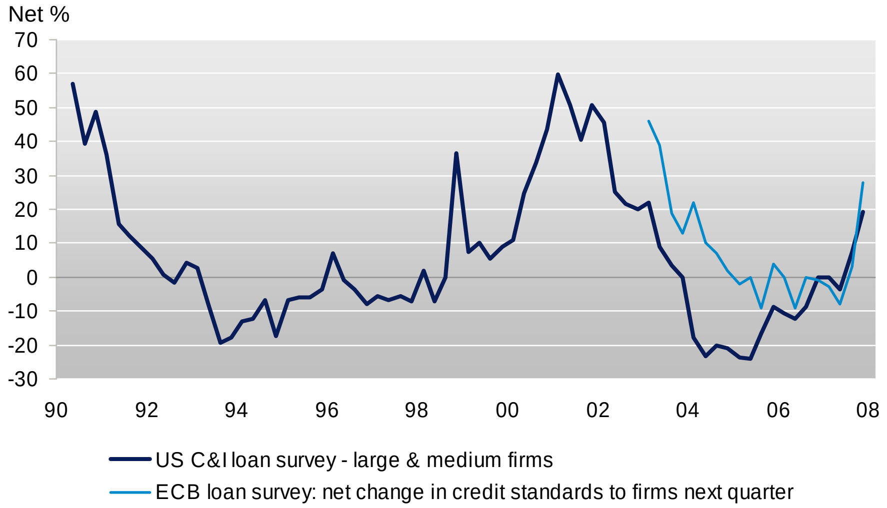


Source: Thomson Datastream

The second is the persistence of problems in the credit markets which means that there is now more danger of the credit crunch spreading to the wider economy. Surveys of the banking sector in the US, Eurozone and UK show that loan officers are tightening the conditions they attach to loans, not just to households but also to corporates (chart 2). Such a tightening normally results in slower GDP growth with a lag of about 6 months.

As a result of these factors we are cutting our forecast for US GDP growth in 2008 to 2.1% from 2.4% with the economy growing at little more than 1% annualised over the fourth quarter of this year and first quarter of next. The economy is expected to pick-up as the housing market bottoms out and oil prices ease back, thus resulting in a modest strengthening of activity in the second half of 2008.

Chart 2: US and ECB loan officers tighten credit

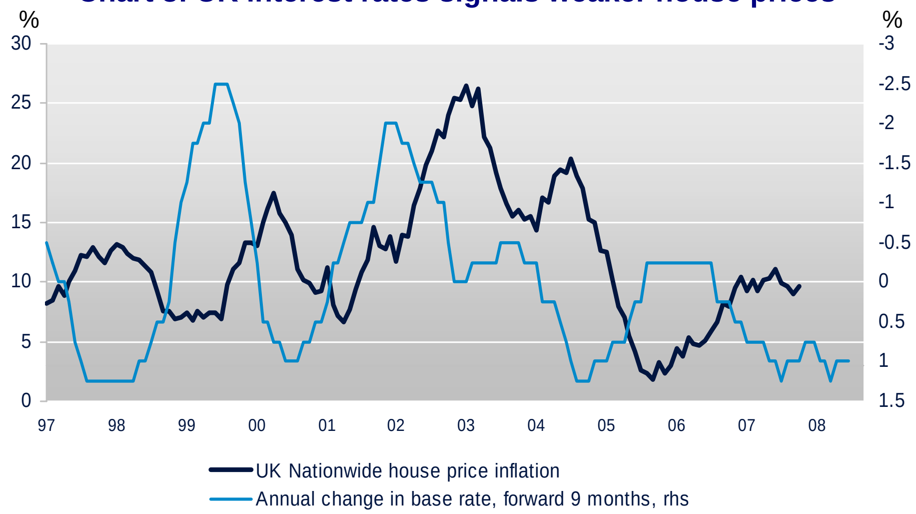


Source: Thomson Datastream

Our forecast for growth in the Eurozone is already below consensus, but the combination of weaker US demand and a stronger Euro than previously expected means we have trimmed the numbers further. Eurozone GDP growth is now at 1.8% for 2008 after an expected 2.5% in 2007.

In the UK, there is also evidence of a slowdown with the housing market cooling in recent months. We would see this as a normal reaction to the tightening of monetary policy by the Bank of England (chart 3), which has been given an added twist in recent months by the credit crisis. This has yet to spread significantly to the retail sector, but with oil and food prices rising we expect a squeeze on spending.

Chart 3: UK interest rates signals weaker house prices



Source: Thomson Datastream

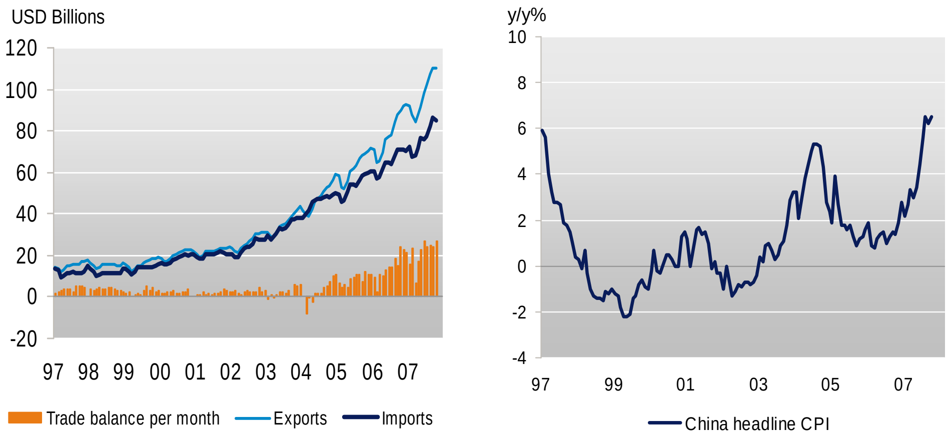
Japan has been hit by a self inflicted slump in housing activity which is reducing activity at present. Despite this, the economy is expected to have recorded positive output growth in the last quarter, after a fall in GDP in the second. Going forward the picture is the same as elsewhere with a number of headwinds likely to dampen activity as we head into year end. Although the economy is less affected by the credit crisis having not gained significant exposure to sub-prime credit, weaker demand from the US and the high oil price are two factors which will weigh on growth.

Emerging markets are not immune, but growth will be less affected by the OECD slowdown

These factors mean that OECD growth will be just 2% in 2008. The emerging markets (EM) are not unaffected and will slow a little from their current growth rate, but our forecast for 2008 is little changed at 6.8%. Strong momentum and liquidity growth suggest that the region will be somewhat de-coupled from the slowdown in the US.

For example, the latest official figures show that China continues to grow rapidly with GDP growth rising at 11.5% in the year to the third quarter. This marked the third consecutive quarter of growth above 11% and the authorities continue to grapple with the economy in an attempt to cool activity. Although there were signs of a modest slowdown on a quarterly basis, the evidence points to a continuation of strength in the current quarter with the trade surplus surging in recent months. Efforts to cool the economy have been given added impetus by the rise in CPI inflation which was running at 6.5% in October and another increase in required reserve requirements was announced on November 10th (charts 4a & 4b).

Charts 4a & 4b: China trade balance and CPI inflation



Source: Thomson Datastream

Our baseline view assumes some cooling of activity in 2008 to 10.5% GDP growth as policy tightening begins to impact fixed asset investment and weaker demand from the US slows exports. A greater slowdown is unlikely in an environment where the Fed is cutting interest rates and the dollar is weakening. Although the authorities are likely to let the RMB rise this is unlikely to significantly choke off export demand.

Overheating danger in China

The root of the problem lies with the policy of foreign exchange intervention which is holding down the RMB to keep China's exports competitive and drawing in foreign direct investment (FDI) from overseas. It may also be contributing to money growth as the authorities have not been 100% successful in sterilising intervention. The result is stronger growth and excess liquidity which is spilling over into asset and consumer prices.

Inflation in China should moderate as food shortages ease, but we would not be surprised to see a pick-up in the core rate (CPI ex. food). This reflects the rise in oil prices, which the authorities have started to pass through to the consumer, and the ongoing strength of activity and money growth.

Monetary policy remains tied to the falling US dollar

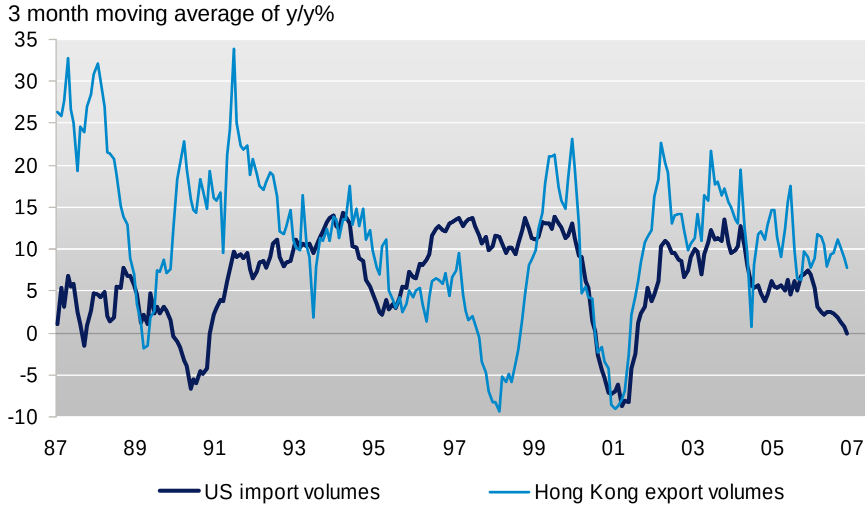
The problems in China can be seen to some degree across the EM as monetary policy is often directly or indirectly tied to the US where monetary conditions are easing. Whilst the EM economies may have de-coupled from the US, their monetary policies remain tightly linked to the dollar and the Fed. Thus, EM monetary policy is being set in line with the slump in the US housing market at a time when growth is above trend and money supply rising at a double digit rate. Such an inappropriately loose setting creates a strong likelihood of inflation and bubbles.

From this perspective the de-coupling argument, widely seen as so positive for the region and its equity markets will backfire as inflation gets out of control. Given the current cyclical position it would be better if there was a significant impact from a slowdown in the US as this would cool the EM and dampen inflationary pressure.

In some respects, the ability of EM economies to break away from US growth is surprising in that exports as a share of GDP remain high and have risen over the past decade as global trade volumes have expanded faster than GDP. China's exports are now some 40% of GDP, for example.

EM economies supply roughly half of total US imports. As yet though sales to the US have not moved down with the slowdown in US import demand (see chart for the example of Hong Kong) suggesting that EM exports are now marching to a different beat. This though will be tested by the switch toward consumer weakness in the US, hitting a different range of suppliers from those affected in 2007 by the housing downturn. China with its significant proportion of consumer goods producers is likely to be affected as the greater import intensity of US consumer spending compared to house building suggests the effect on Asian exports will be greater.

Chart 5: US imports and Hong Kong export volumes



Source: Thomson Datastream

However, while trade links are important they are not the only connection between economies. Financial links also play a role, through either the exchange rate or equity markets. Stronger exchange rates would dampen activity to the extent that currencies are allowed to appreciate. The links between equity markets are also important, more so now given the spectacular rise in market capitalisation as a share of GDP (table 1).

Table 1: Stock market capitalisations as % GDP

	2003	Sep-2007
Argentina	56%	27%
Brazil	33%	198%
China	35%	252%
India	34%	171%
Indonesia	18%	57%
Mexico	18%	132%
Russia	41%	153%
South Africa	137%	667%
Thailand	58%	71%
US	117%	174%

Source: DB Global Markets Research

This suggests that a shock from the US to EM equity markets could result in a more significant impact on EM growth than seen so far by reinforcing the impact from trade.

Inflation and monetary policy in the OECD

Will policymakers focus on growth or inflation?

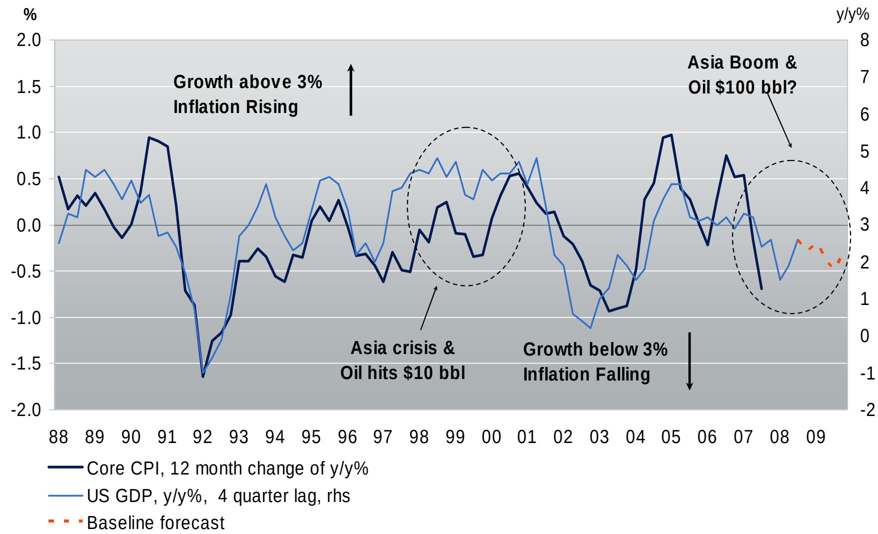
The higher profile for oil prices pushes up the headline inflation forecast for 2008 across the OECD and to an average of 3.1% for the US (previously 2.7%). This will present a dilemma for policymakers who will be torn between responding to the deterioration in growth against the rise in prices.

Policy makers will be prepared to look through a high headline rate of inflation if they believe that the increase is temporary and is not influencing long term consumer inflation expectations, or feeding through into wider inflation measures beyond food and energy (i.e. core CPI). In this case, they can be confident that a rise in commodity prices is not becoming entrenched in future inflation.

Central banks do not claim to be experts on predicting commodity prices and, like us, will use the forward curve to derive their assumptions. On this basis the crude oil price, currently $95/ b for Brent should modestly decline in 2008 and end the year at $87/ b. This will mean that oil prices will add to annual headline inflation throughout 2008 until the final quarter of the year. There is a risk that this does begin to influence inflation expectations, however oil price forecasts are very uncertain and will have to be balanced against other factors influencing inflation.

The most important of these is the strength of growth and amount of slack in the economy. One relationship which continues to work well in the US is simply the rate of GDP growth over the past year pushed forward 12 months against the change in core inflation. When growth falls below 3%, core inflation decelerates over the following year and when growth is above 3% inflation accelerates (chart 6). Underlying this is the idea that trend growth in the US is around 3% and that a period of a year is normally long enough to generate sufficient slack or tightness to push inflation down or up.

Chart 6: Growth and inflation in the US



Source: Thomson Datastream, Schroders

At 2.6% GDP growth the US economy is currently in the zone where inflation decelerates and has been since the second quarter of 2006, the last time the economy achieved above trend growth. Core inflation is responding having fallen from 2.9% in September last year to 2.1% today. The lags mean that disinflationary pressure will persist through 2008 and, if our growth forecasts are correct, into 2009. Against this backdrop, it would seem that there is little danger of inflation accelerating and that the greater fear should be deflation.

There are two qualifications to this conclusion. The first is that the trend rate of growth may have slowed. Evidence for this is from the unemployment figures which show that the jobless rate has been little changed over the past 18 months despite sub-trend growth. This observation is corroborated by the slowdown in productivity growth and suggests that the economy has to be weaker than before to generate the slack which will contain inflation. Our own estimate of the output gap used in the analysis of market performance in different stages of the economic cycle calculates the output gap from unemployment and capacity utilisation and suggests that the US economy is still operating above trend at present. Against this is the absence of any strong wage pressure and the fall in inflation itself, evidence that trend growth is still close to 3%.

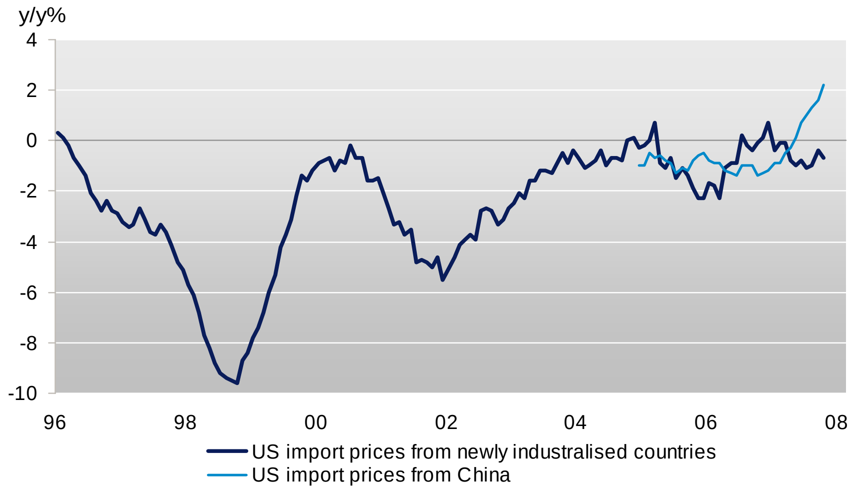
Although little changed over the past 18 months, the unemployment rate has been rising since March and our view is that it will continue to move upward in coming months as growth slows further. An outcome which should generate the slack necessary to quell inflation.

A less deflationary global environment

The second qualification is the global environment. Global factors are playing a more important role in determining domestic inflation – a view given empirical backing by recent research which finds that measures of the global output gap significantly add to the explanation of inflation in a range of OECD countries[1]. This has generally worked to cause inflation to be lower than would have been expected from domestic factors alone.

An example of this effect is apparent in chart 6 above where, in the second half of the 1990s, strong above trend growth in the US did not generate an acceleration in inflation. This period coincided with the Asia crisis where growth in the region slumped and exchange rates fell sharply. The resulting export led recovery contributed to deflationary pressures in the world economy with imported goods prices falling in many OECD (chart 7). Low oil prices also contributed with oil hitting $10/ b in 1996.

Chart 7: Less deflationary - US import prices from Asia



Source: Thomson Datastream

1 Globalisation and inflation, Borio and Filardo, BIS Working paper May 2007

Today the environment is not as deflationary. US import prices from the Asian Newly Industrialised Countries (NICs) are still falling, but by only around 1%, rather than 10%, and prices from China are now rising. Meanwhile, oil prices are nearly 10 times higher and have been rising sharply. This suggests that global forces are at best neutral and may be turning inflationary rather than deflationary.

On balance, our central forecast assumes that core inflation remains well behaved and in the US moderates further to average 2% in 2008. Weaker activity should beget higher unemployment leading to a fall in wage pressure, whilst slower demand should limit pricing power. These factors should prevent any major spillover from higher oil prices into more general inflation.

Thus, despite higher headline inflation we now expect the Federal Reserve to ease policy further with the Fed funds target falling to 3.75% in the first quarter of next year. We expect rates will then remain at that level for the remainder of the year.

For the ECB, the same debate may lead to a different conclusion given their greater emphasis on inflation as a goal of monetary policy. Nonetheless, we still expect the ECB to ease policy twice in 2008 in response to the strength of the Euro and slowdown in activity.

For the UK, the rise in sterling against the dollar has been largely offset by weakness against the Euro with the result that the UK trade-weighted exchange rate has been broadly stable. Consequently, the UK does not face the same pressure as the Euro area. Nonetheless, we expect the slowdown in activity to be sufficient to prompt an easing of monetary policy by the Bank of England with the first move in February next year. The Bank signalled as much when releasing its latest Quarterly inflation report.

Going against the trend in the US and Europe, central banks in Asia can be expected to tighten, to the extent that their monetary arrangements allow. Interest rates have risen in Australia and the Bank of Japan (BoJ) continue to indicate that interest rates will need to rise. However, in the case of the latter there will be little scope to achieve this until activity is on a firmer footing. We now expect the first move in June next year, with Japanese policy rates ending the year at 1%.

Risks and scenarios

We see two principal risks to the central scenario. One is that the credit crunch spreads more deeply to the real economy resulting in several quarters of falling GDP in the US and a global slump. In this scenario, inflation falls significantly and fears that the US is entering a Japan style deflation mean that the Fed slashes interest rates sharply. This generates a modest upturn in the second half, but activity is still sub-trend. We would attach a probability of 15% to this outcome.

The second is a stagflation scenario where we get both slower growth and higher inflation than in the baseline. In the near term, this is precisely how the world economy will be described as headline inflation rates rise and growth slows. The difference is that in this scenario, core inflation also accelerates and despite the weakness of activity and higher unemployment the Fed and others actually tighten rates in 2008. This stifles any hope of an upturn and growth is weak through 2008.

In effect, this amounts to a resolution of the debate outlined above on inflation in the most adverse way as the trade-off between growth and inflation deteriorates. Our view is that there is marginally higher risk of this outcome at 20%. Overall, this analysis points to a 35% probability that the US experiences an outright recession next year.

I. Forecast summary

Real GDP

y/y%	Wt (%)	2005	2006	2007	Consensus	2008	Consensus
US	32.7	**3.1**	**2.9**	2.1	2.1	2.1	2.3
UK	5.9	**1.8**	**2.8**	3.1	3.0	1.8	1.9
Eurozone	26.6	**1.5**	**2.9**	2.5	2.6	1.8	2.0
Japan	13.0	**1.9**	**2.2**	1.9	2.0	1.8	1.8
Australia	1.6	**2.8**	**2.7**	4.1	4.3	3.3	3.7
OECD	79.8	**2.3**	**2.8**	2.3	**2.4**	2.0	**2.1**
China	5.8	**10.4**	**10.7**	11.4	11.3	10.5	10.5
Emerging*	20.2	**6.5**	**7.1**	7.1	7.1	6.8	6.7
World	100.0	**3.1**	**3.6**	3.3	**3.3**	2.9	**3.0**

Inflation CPI

y/y%	Wt (%)	2005	2006	2007	Consensus	2008	Consensus
US	32.7	**3.4**	**3.2**	2.9	2.8	3.1	2.6
UK	5.9	**1.9**	**2.7**	2.3	2.3	2.0	2.0
Eurozone	26.6	**2.2**	**2.1**	2.1	2.0	2.4	2.1
Japan	13.0	**0.0**	**0.1**	-0.1	0.0	0.3	0.4
Australia	1.6	**2.7**	**3.5**	2.3	2.3	2.6	3.0
OECD	79.8	**2.3**	**2.3**	2.1	**2.0**	2.3	**2.0**
China	5.8	**1.8**	**1.5**	4.6	4.5	4.5	3.8
Emerging*	20.2	**4.6**	**4.5**	4.9	5.1	5.0	4.7
World	100.0	**2.8**	**2.8**	2.6	**2.7**	2.9	**2.6**

* ***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 (weights are at 2005 US$)*

Interest rates

%	Wt (%)	Dec-05	Dec-06	Dec-07	Market	Dec-08	Market
US	32.7	4.25	5.25	4.25	4.72	3.75	3.87
UK	5.9	4.50	5.00	5.75	6.17	5.00	5.27
Eurozone	26.6	2.25	3.50	4.00	4.51	3.50	4.08
Japan	13.0	0.10	0.25	0.50	0.83	1.00	0.96
OECD	78.2	**2.90**	**3.81**	3.66	4.11	3.30	3.56

Market from forward futures strip as at 12/11/2007

Key variables

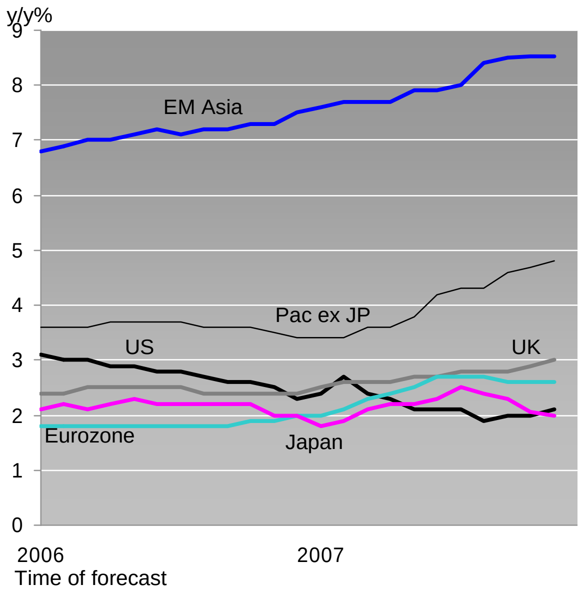
FX	*Current*	Dec-06	Dec-07	y/y%	Dec-08	y/y%
USD/ GBP	*2.05*	1.96	2.10	7.0	2.03	-3.3
USD/ EUR	*1.45*	1.32	1.50	13.6	1.43	-5.0
JPY/ USD	*109.6*	117.4	105.00	-10.6	107.00	1.9
GBP/ EUR	*0.70*	0.67	0.71	6.2	0.70	-1.7
Brent crude	*91.5*	62.3	88.0	41.3	87.5	-0.6
US output gap %GDP	*0.3*	0.3	0.0		-0.6	
Unemploy. %	*4.5*	4.5	4.9		5.3	

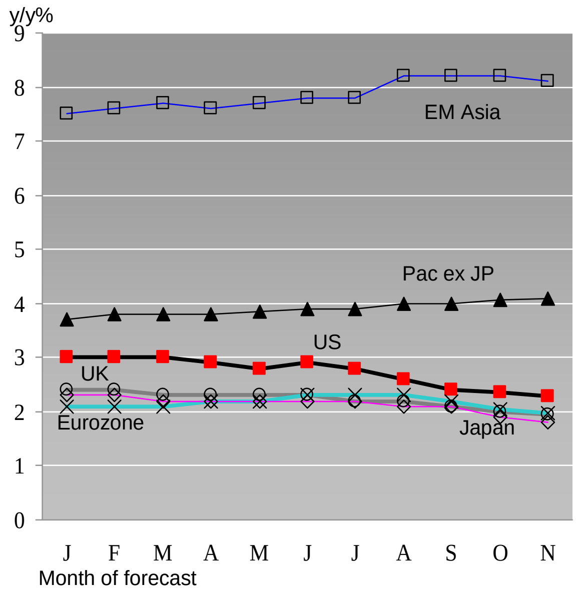
Source: Schroders, Datastream, IMF (historic), Consensus Economics (November)

II. Updated forecast charts

Chart 1: GDP forecasts

2007	2008



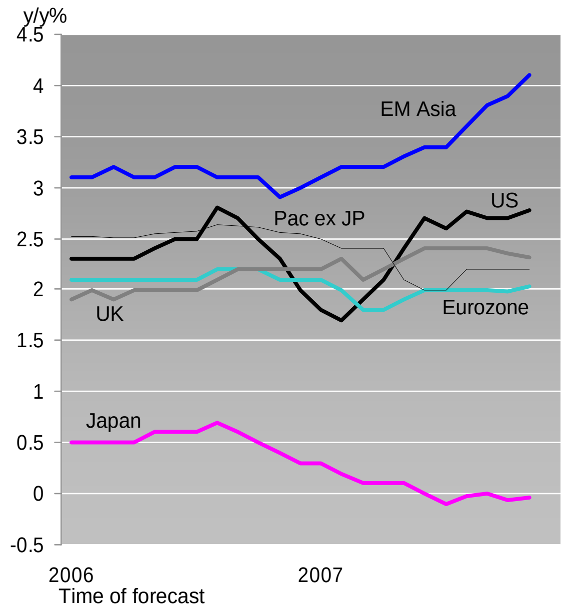


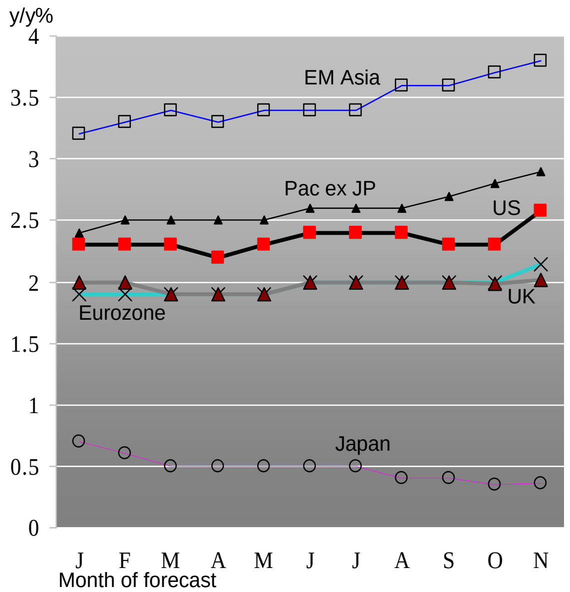
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

Source: Consensus Economics (Nov.), Schroders 2005 GDP weights

Chart 2: Inflation forecasts

2007	2008

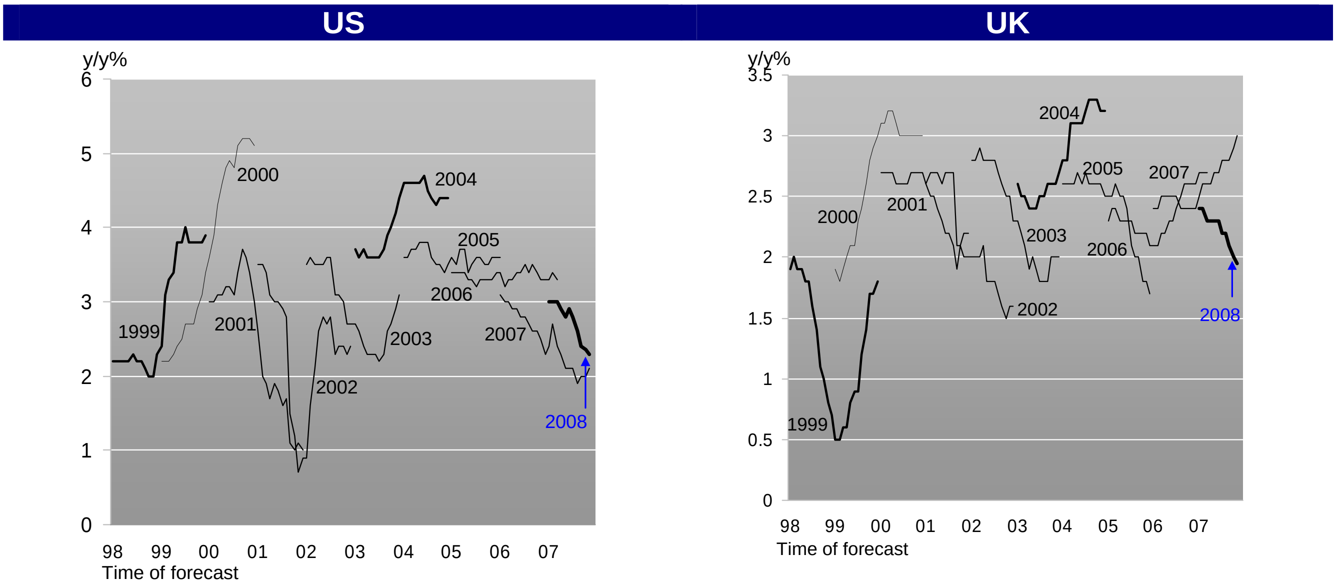




Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

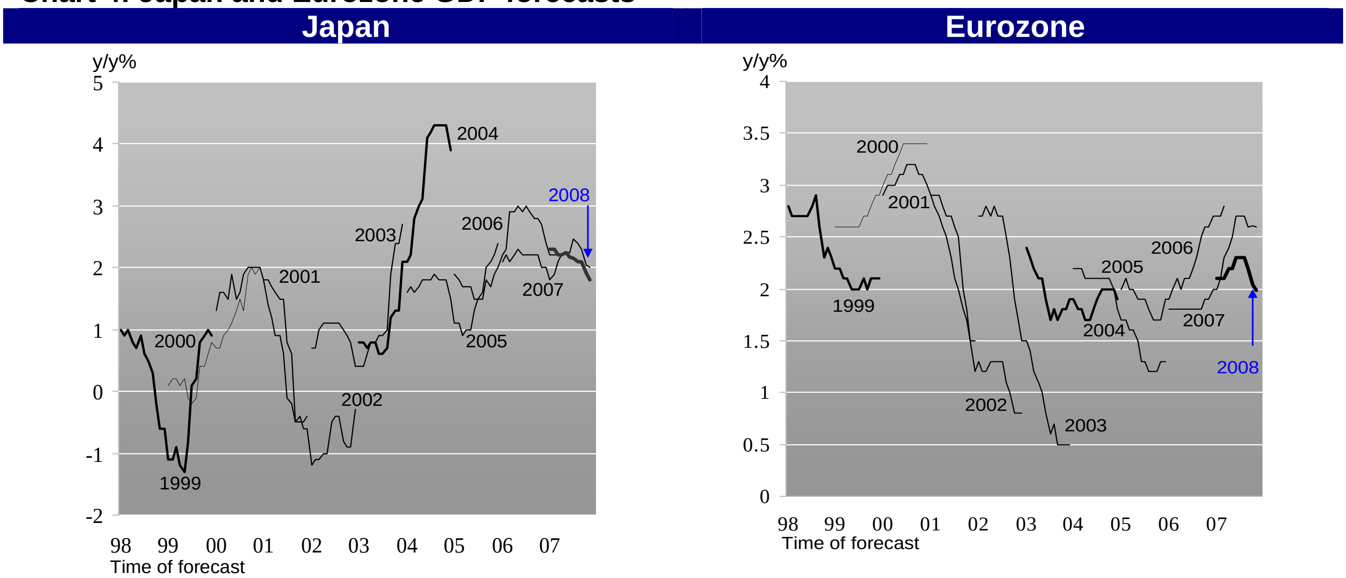
Source: Consensus Economics (Nov.), Schroders 2005 GDP weights

Chart 3: US and UK GDP forecasts



Source: Consensus Economics (Nov.), Schroders

Chart 4: Japan and Eurozone GDP forecasts



Source: Consensus Economics (Nov.), Schroders

The views and forecasts contained herein are those of Schroders Investment Management's Economics Team, and do not necessarily represent Schroders Investment Management's house view.