Schroders
Economics and Strategy Viewpoint

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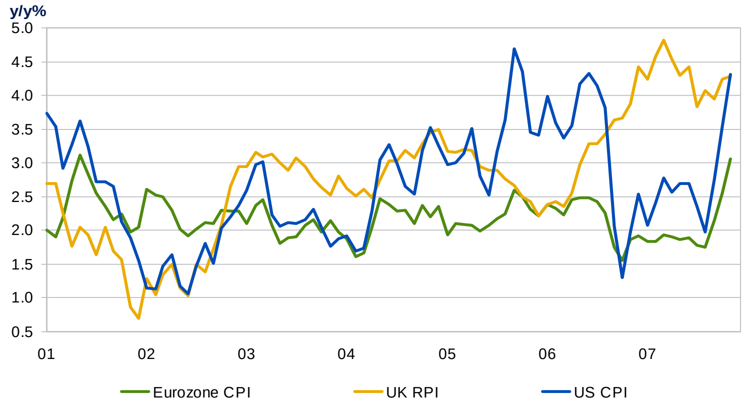
Global Views: Inflation fears trouble investors (page 2)

- **The rise in headline inflation rates has increased investor concerns that central banks will be unable to focus on growth and ease policy further in coming months. This is a genuine risk and heightened inflation fears are typical of this late phase of the cycle.**
- **Our view remains that slower growth will quell these fears in the New Year. The stability of core inflation (CPI ex. food and energy) rates during the recent pick up in headline rates should also reinforce central bank confidence that the increase in commodity prices will not spill over into wider prices for goods and services.**
- **The exception to this is in the Eurozone where core inflation has been accelerating and, given the European Central Bank's continuing hawkish stance, we are pushing rate cut forecasts out into the second half of next year.**
- **The latest attempt by central banks to unblock the financial system through a series of money market auctions is a step in the right direction, but has only had limited success so far. Watch for further action in the New Year.**
- **As inflation concerns fade the backdrop for risk assets should improve. However, weaker growth will squeeze profit margins and analysts have some way to travel before they arrive at realistic profits forecasts for 2008. A year of corporate earnings downgrades is in prospect.**
- **From a strategy perspective, we are keeping our powder dry and are cautious on equities until markets look to reassess the outlook for inflation and earnings. Following a period of softer activity, the conditions for a sustainable recovery should fall into place. Only at this point, will central banks be seen to be ahead of the curve and risk assets return to the fore.**

Forecast summary (page 6)
Chart of the month: Headline inflation rates have risen sharply



Source: Thomson Datastream

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Global Views

Inflation fear trouble investors

Concern that higher inflation will prevent central banks from easing

Judging from the questions at our recent Teleconference, inflation is top of the agenda for investors at present[1]. The latest figures show an increase in pipeline pressures with producer prices increasing at their fastest rate for 16 years in the UK. At the consumer level inflation rates have also picked up with Eurozone inflation reaching 3.1% and the US CPI rising 4.3% in November, a 2 year high (see chart on front page). Inflation has also risen further in China, hitting 6.9% in November.

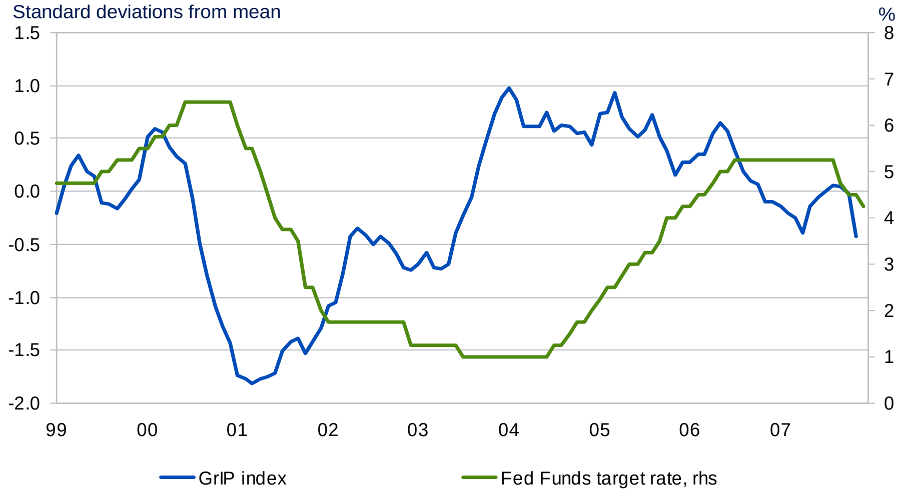
The clear concern is that higher inflation will prevent central banks from easing policy and supporting activity. Consequently, risk assets have suffered with equity markets selling off.

We discussed this issue in some detail in the last Economic Viewpoint arguing that "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)".

Growth turning down in the US

In brief, our view is that should the slowdown in activity materialise as we expect then sufficient slack should be created to enable inflation to fall. The risk to this is that growth fails to slow or sufficient slack is not created due to slower productivity growth. Both are possibilities, although the recent decline in our US Growth and Inflationary pressures index (GrIP) suggests that the slowdown is well in train. Every component of the GrIP except the dollar fell in November with the greatest weakness in consumer confidence and durable goods orders.

Chart 1: Growth and inflationary pressures easing in the US



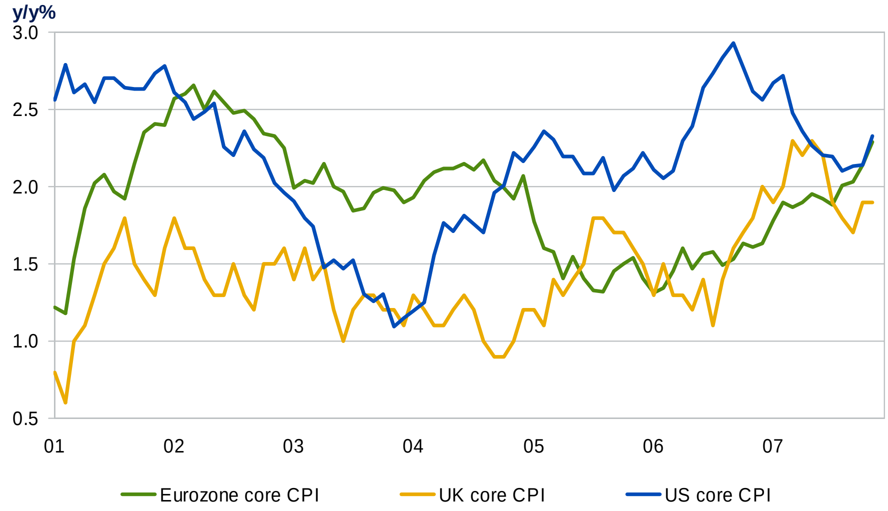
Source: Schroders
The GrIP index summarises the behaviour of 11 key indicators in the US and is designed to monitor growth and inflationary pressures.

[1] Economics and market teleconference playback available at http://mediazone.brighttalk.com/comm/Schroders/32b92f9879-6157-334-5730

Core inflation behaving in the US and UK, but not in the Eurozone

As far as core inflation (CPI ex. food and energy) is concerned the picture is more mixed. In the UK and the US the core rate has stabilised, but is down from the levels reached a year ago. In the Eurozone, the core rate has been on a steady ascent for the past 18 months and has recently moved above 2% (see chart 2). From this perspective, it is not difficult to understand the recent comments from ECB President Trichet when he said that the rate setting council considered a rate hike at their last meeting. We are pushing our forecast for an ECB rate cut into the second half of next year with the first move now expected in July.

Chart 2: Core inflation rates



Source: Thomson Datastream

On a more worrying note, there is some evidence that inflation expectations have picked up. Surveys in both the US and UK show households perceptions of the current inflation rate have ticked up, as have their expectations of the future rate. So far, these have not fed through into higher wage rates, but clearly this is a potential risk.

Markets and strategy

Central banks attempt to unblock the system,

The issue of policy direction has been given an added twist by the news that central banks would pump extra liquidity into financial markets through a series of auctions. This can be seen as a co-ordinated response to the blockage created by the credit crunch in money markets which is preventing changes in policy rates from reaching the real economy. The aim of the latest move is to clear the system so that rate cuts flow through to households and consumers rather than being absorbed in wider LIBOR (London Inter Bank Overnight Rate) spreads.

…with limited success so far

Clearly, this is a step in the right direction and increases the chances of recovery. However, markets have taken fright at how little effect it has had so far with LIBOR and TED spreads (the difference between 3 month US Treasury bills and 3 month LIBOR) remaining at extended levels (see charts 3a and 3b on next page). The more paranoid suggest

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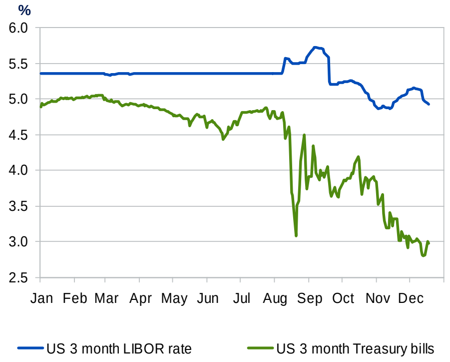
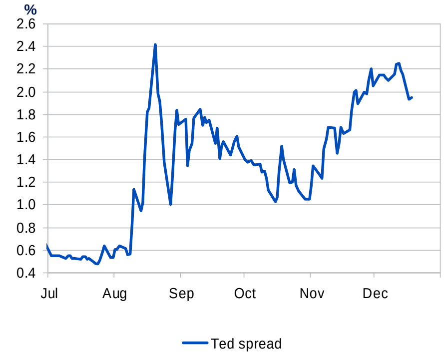
that the action reflects something very bad in the system that only the central banks know about. Either way, it looks as though the auctions will need to be stepped up in the New Year if the policy is to succeed.

Charts 3a and 3b: Ted spread signals ongoing concern in financial system





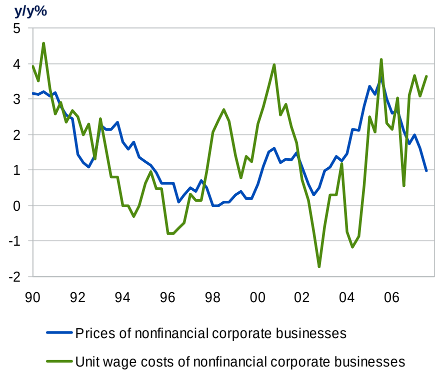
Source: Thomson Datastream

Profits in 2008: analysts have some way to travel

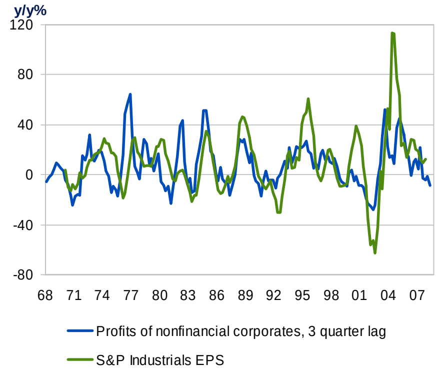
For equity investors, the more cautious tone is reinforced by the latest top-down profit figures in the US. These show that the profit share appears to have peaked out more than a year ago and has now started to decline. Underlying this is the acceleration in unit labour costs at a time when prices (in the non-financial part of the economy) are decelerating – a classic margin squeeze (chart 4a). This matters as the top down profits figures (non-financials) lead S&P500 earnings by three quarters and signal that the latter will be in negative territory on a year-on-year basis in the first half of 2008 (chart 4b). Against this backdrop, the bottom up consensus for a *rise* in S&P500 earnings looks set for a major disappointment.

Charts 4a and 4b: Profitability in the US is set to disappoint

Prices and costs of US businesses



US economic profits and EPS growth



Source: Thomson Datastream

The inability of firms to preserve their margins is another sign that inflation will not be a major problem. However, it is a reminder that the cost of inflation control is weaker profits.

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Cautious strategy for the new year

In terms of strategy, we go into the New Year on a cautious tack, having moved underweight equities. Within equities we prefer defensive trades: long large versus small cap equities and long growth against value. We have also raised our weighting in the US equity market at the expense of the higher beta Europe ex.UK. However, we still have an overweight in emerging markets. We have increased our exposure to cash and hedge funds as a result of reducing equities[2].

Underlying this is our assessment that this is a difficult stage of the cycle for equity markets which tend to be volatile and underperform cash. The persistence of inflation worries is typical of this phase which marks the end of a long expansion and requires a period of weaker growth before the economy can enjoy a sustainable recovery. Once we move into this phase and central banks are seen to be ahead of the curve, risk assets will return to the fore.

[2] The Global Market Perspective, Q1 2008 explains our latest strategy views in more detail.

Forecast Summary

I. Forecast summary

Real GDP

y/y%	Wt (%)	2005	2006	2007	Consensus	2008	Consensus
US	32.7	3.1	2.9	2.1	2.2	2.1	2.1
UK	5.9	1.8	2.8	3.1	3.1	1.8	1.9
Eurozone	26.6	1.5	2.9	2.5	2.6	1.8	1.9
Japan	13.0	1.9	2.2	1.9	1.8	1.8	1.5
Australia	1.6	2.8	2.7	4.1	3.9	3.3	3.6
OECD	79.8	2.3	2.8	2.3	2.4	2.0	2.0
China	5.8	10.4	10.7	11.4	11.3	10.5	10.5
Emerging*	20.2	6.5	7.1	7.2	7.2	6.9	6.6
World	100.0	3.1	3.6	3.3	3.3	3.0	2.9

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	2.1
Eurozone	26.6	2.2	2.1	2.1	2.1	2.4	2.3
Japan	13.0	0.0	0.1	-0.1	0.0	0.3	0.4
Australia	1.6	2.7	3.5	2.3	2.4	2.6	2.9
OECD	79.8	2.3	2.3	2.1	2.1	2.3	2.1
China	5.8	1.8	1.5	4.6	4.6	4.5	4.1
Emerging*	20.2	4.6	4.5	4.9	5.3	5.0	5.0
World	100.0	2.8	2.8	2.6	2.7	2.9	2.7

** **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	4.94	3.75	3.59
UK	5.9	4.50	5.00	5.50	6.34	5.00	5.13
Eurozone	26.6	2.25	3.50	4.00	4.95	3.50	4.36
Japan	13.0	0.10	0.25	0.50	0.86	1.00	0.81
OECD	78.2	2.90	3.81	3.64	4.37	3.30	3.51

Market from forward futures strip as at 18/12/2007

Key variables

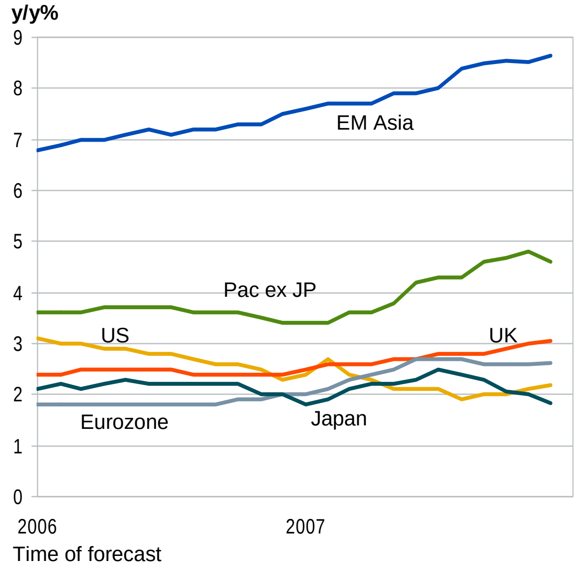
FX	*Current*	Dec-06	Dec-07	y/y%	Dec-08	y/y%
USD/ GBP	*2.01*	1.96	2.10	7.0	2.03	-3.3
USD/ EUR	*1.44*	1.32	1.50	13.6	1.43	-5.0
JPY/ USD	*113.3*	117.4	105.00	-10.6	107.00	1.9
GBP/ EUR	*0.71*	0.67	0.71	6.2	0.70	-1.7
Brent crude	*90.9*	62.3	88.0	41.3	87.5	-0.6
US output gap %GDP	*0.3*	0.3	0.0		-0.6	
Unemploy. %	*4.5*	4.5	4.9		5.3	

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

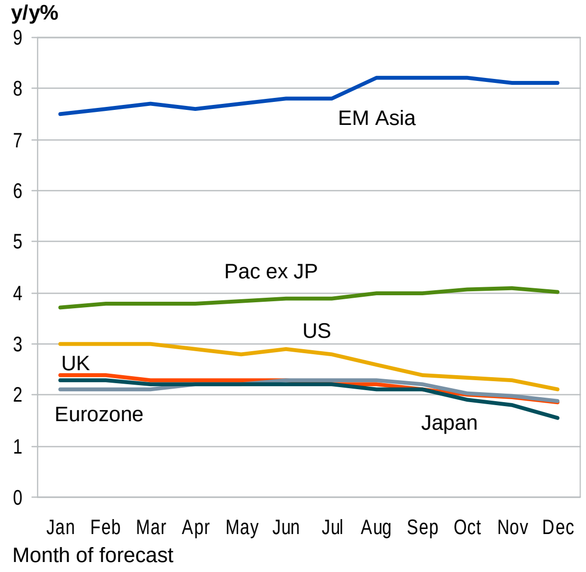
II. Updated forecast charts

Chart 1: GDP forecasts

2007



2008

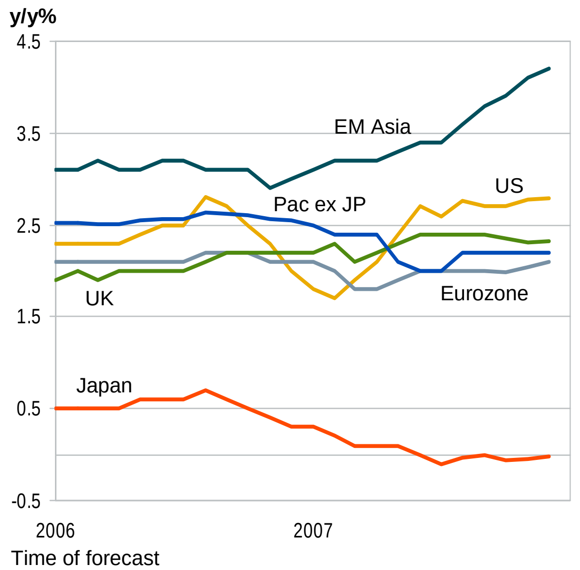


Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

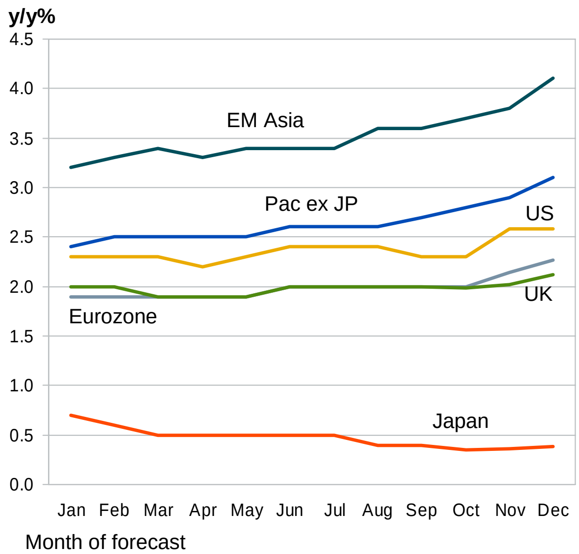
Source: Consensus Economics (Dec.), Schroders
2005 GDP weights

Chart 2: Inflation forecasts

2007



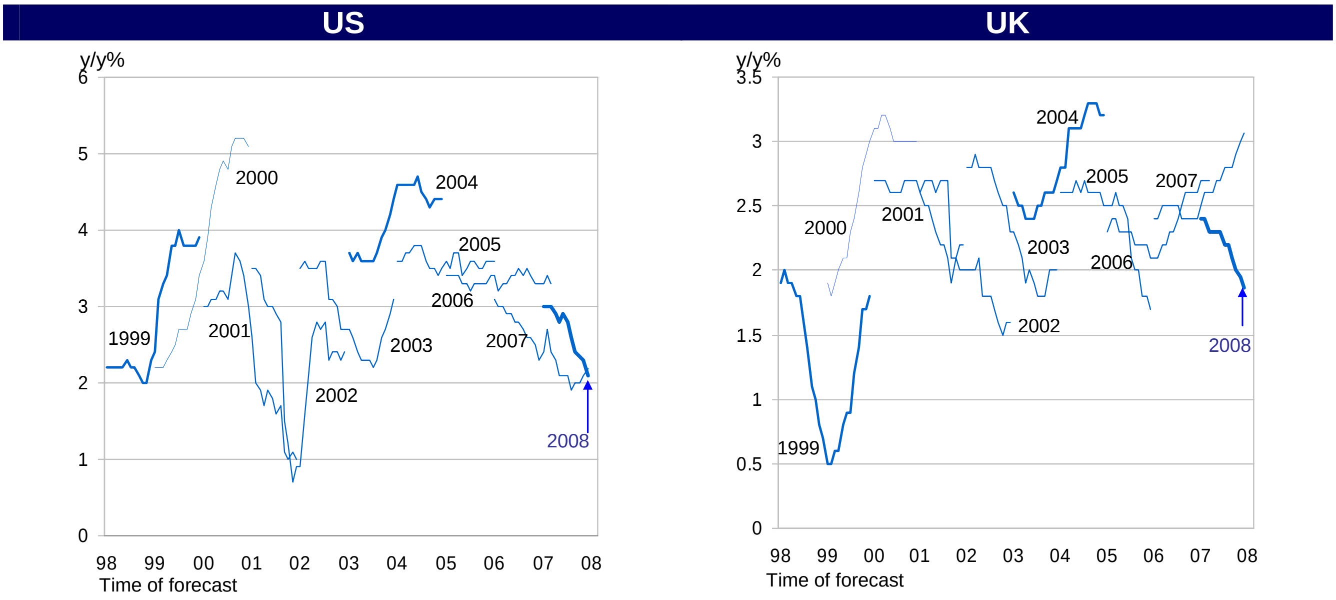
2008



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

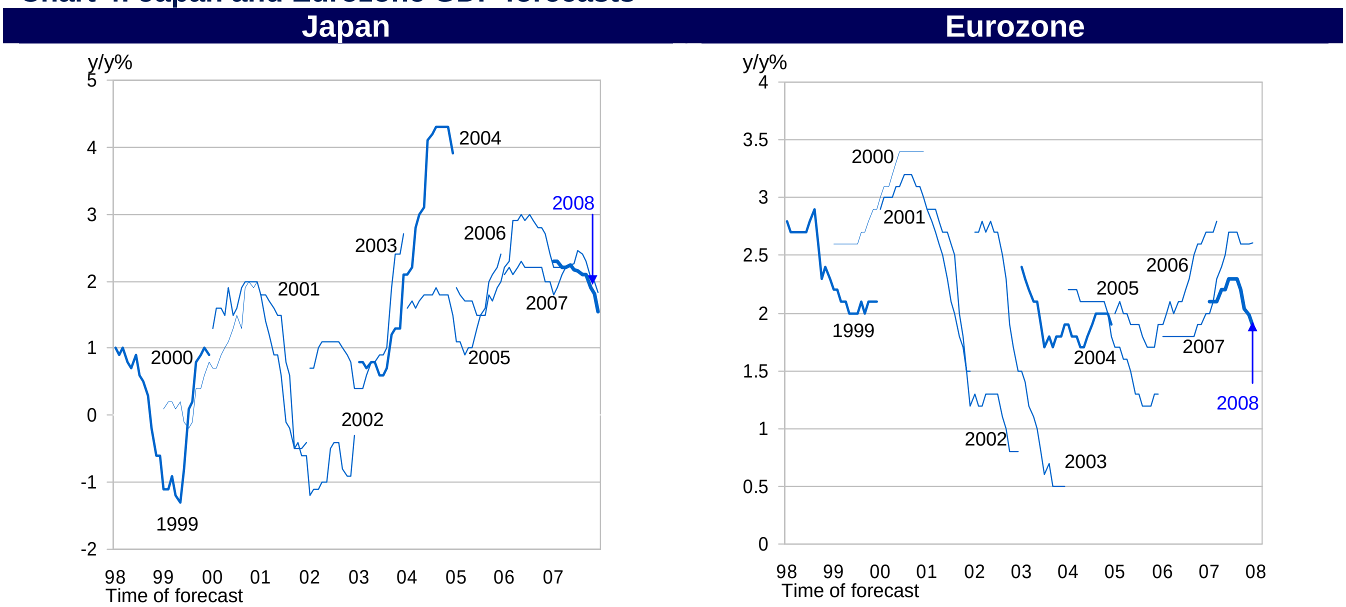
Source: Consensus Economics (Dec.), Schroders
2005 GDP weights

Chart 3: US and UK GDP forecasts



Source: Consensus Economics (Dec.), Schroders

Chart 4: Japan and Eurozone GDP forecasts



Source: Consensus Economics (Dec.), Schroders

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