Schroders
Economics and Strategy Viewpoint

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Global: US rates – lower for longer (page 2)

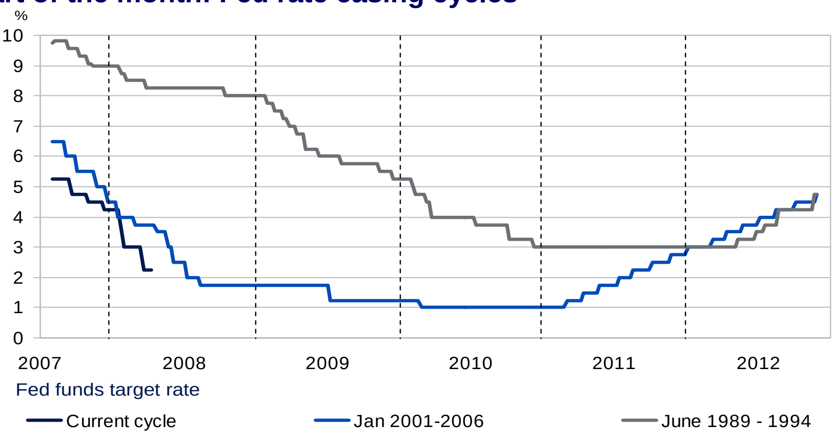
- **Recent action by the Federal Reserve appears to have reduced the tail risk associated with an outright financial meltdown. However, stresses within the financial sector remain and the transmission mechanism from monetary policy to the real economy is impaired.**
- **This can be seen in the mortgage market where the Fed has achieved considerably less "bang for its buck" in this cycle compared to the past three episodes of rate easing. We attribute this to heightened risk aversion as the response of Treasury yields has not been particularly different this time.**
- **Consequently, relief to the housing market will come slowly and only after further rate cuts. This suggests that the current rate cycle is likely to follow the pattern seen in the past two major easing periods with rates staying low throughout 2009 and possibly into 2010 (see chart below).**

Europe: Growing divergence in Eurozone (page 6)

- **There are increasing signs that the regional north-south divergence within the EMU countries is intensifying.**
- **Germany and France on the one hand are helped by strong capital goods exports. But the Euro will provide a headwind to growth. Italy appears to be on the brink of a recession with Spain at risk of a sharp decline.**
- **The drop in house prices across Europe leaves countries like the UK, Spain and Ireland vulnerable to a sharp correction in economic activity.**
- **The forthcoming ECB Credit survey, out in early May, should highlight the extent to which tight credit is impacting the Eurozone and lead to a cut in interest rates soon after.**

Forecast summary (page 14)

Chart of the month: Fed rate easing cycles



Source: Thomson Datastream as at 15/04/2008

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Global

Capitalism without financial failure is not capitalism at all, but a kind of socialism for the rich. - James Grant, Grant's Interest Rate Observer

Fed draws a line in the sand,

Financial markets have stabilised over the past month, an outcome largely attributed to the Federal Reserve's bailout of the investment bank Bear Sterns. Relief that the financial sector would not meltdown and take the economy with it are believed to have underpinned the strengthening in equity and credit markets.

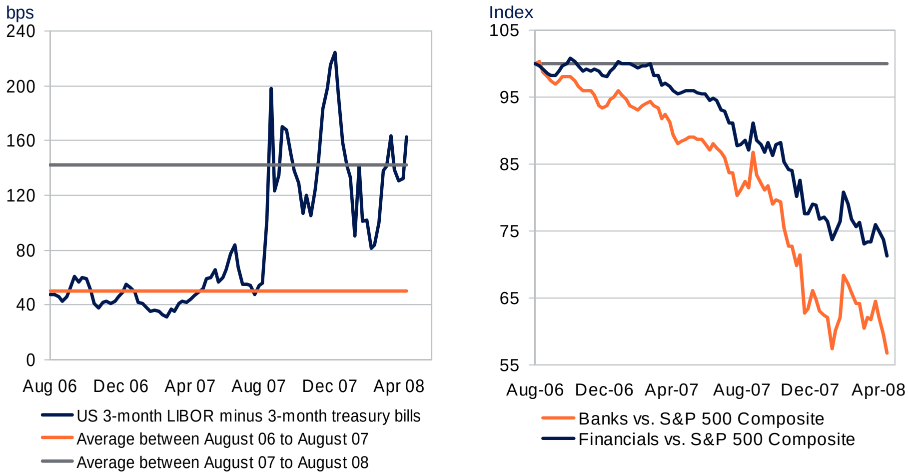
Questions about whether the US central bank should be taking on such a risk remain to be answered. Some have called it the death of free market capitalism[1]. Many have noted the divergence between the authorities' treatment of firms in industries outside the financial sector and those within it which must be saved to "prevent systemic failure". Complaints of a socialism for the rich are not unfounded and will no doubt be addressed by future regulation, a process kicked off at the recent G7 meeting in Washington.

Nonetheless, the perception that the Fed has drawn a line under the current crisis is strong. It is not just the decision to help facilitate the purchase of Bear by backing a loan to JP Morgan, but the provision of liquidity to parts of the system which others could not reach. Judging from the Fed's weekly balance sheet this "Carlsberg" solution is now providing more than $140 billion to the banking sector.

but the financial markets remain stressed

Despite these developments, considerable strains in the financial system remain elevated. For example, the TED spread between Treasury bonds and LIBOR (London Interbank Offered Rate) yields is elevated and well above its pre-crisis levels. Meanwhile, in the equity markets the share prices of banks and the wider financial sectors have yet to register a sustained improvement in relative performance (charts 1 & 2).

Charts 1 & 2: Continued stress in financial sector



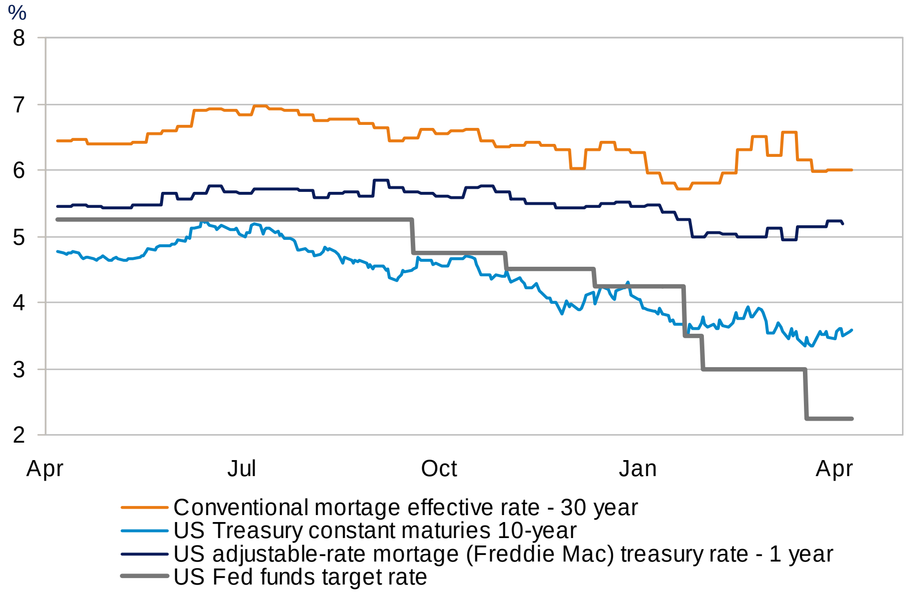
Note: Average between August 07 to August is 08 is using data from August 07 to April 08. Source: Thomson Datastream

[1] Martin Wolf, Financial Times , March 25th 2008

Focus on the transmission mechanism from policy to the real economy

These strains mean that monetary policy is struggling to gain traction. The high risk premium attached to banks means that their cost of capital is not falling in line with policy easing by the authorities. This can be seen in the mortgage market where falls in Fed funds and Treasury bond yields have not translated into significant falls in the cost of borrowing for house purchase (see chart 3).

Chart 3: Selected interest rates in the US



Source: Thomson Datastream

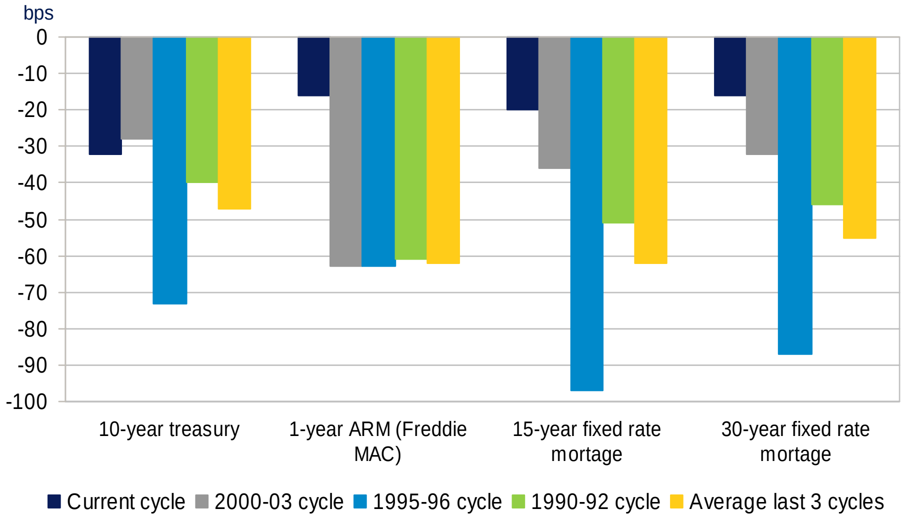
Comparing the current easing cycle with those in the past, the Fed has had less impact for every 100 basis points it has cut the funds rate on mortgage rates, either adjustable or fixed. Following the first cut in Fed funds rate on September 18th last year, the 300 bps fall in the Fed funds target rate since then has translated into a 95 bps fall in Treasury 10 year yields and a drop in mortgage rates of between 47 bps (on ARMs) to 60 bps (on 15 year fixed rates). The picture is actually better than a month ago as fixed rates have fallen following the decision to allow Fannie Mae and Freddie Mac to deploy more capital in the mortgage market. Adjustable Rate Mortgages (ARMs), however, have not responded and rates have backed up over the past month.

Table 1: Fed funds, Treasury yields and mortgage rates

			Mortgage rates		
	Fed funds	**10y Treasury**	**1y ARM**	**15y Fix**	**30y Fix**
14 April 2008	**2.25**	**3.53**	**5.19**	**5.66**	**6.01**
	Change since peak in Fed Funds rate				
This cycle 2007-	**-3.00**	**-0.95**	**-0.47**	**-0.60**	**-0.48**
1990-92 cycle	-5.25	-2.11	-3.22	-2.69	-2.40
1995-96 cycle	-0.75	-0.55	-0.47	-0.73	-0.65
2000-03 cycle	-5.50	-1.54	-3.48	-1.98	-1.77
Avg last 3 cycles	**-3.83**	**-1.40**	**-2.39**	**-1.80**	**-1.61**

Source: Thomson Financial, Schroders

Chart 4: Impact of 100bps Fed easing on US mortgage rates



Source: Thomson Datastream, Schroders

Fed policy is having less effect on mortgage rates

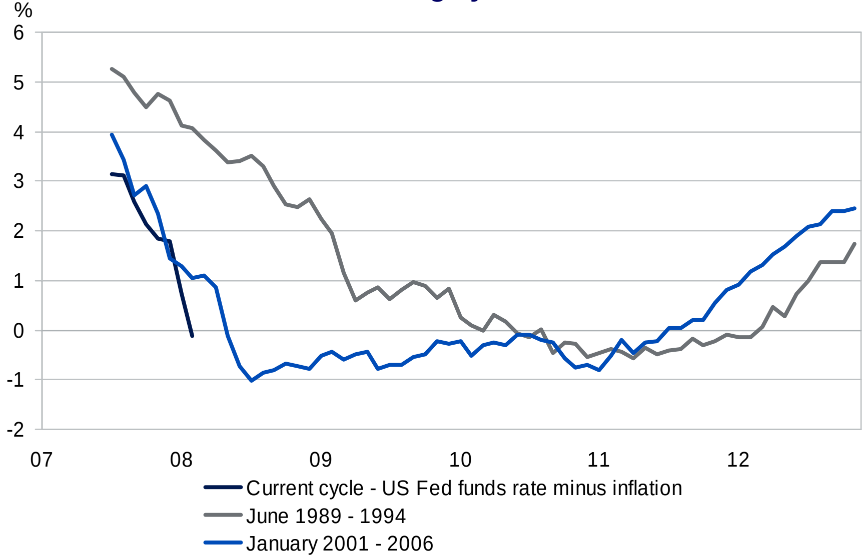
The decline in bang-for-buck from the Fed can be seen if we re-scale these changes into movements per 100 basis point cut in Fed funds rate. These show that the impact of a given move in the Fed funds on mortgage rates has been less in this cycle than that seen in the past three easing periods. Note that the move in 10 year Treasury yields has not been far short of what would have been expected on past experience, but ARM's and fixed mortgage rates have been sticky (chart 4). This would suggest that it is the credit risk, rather than duration, which is driving the cost of borrowing.

Arguably, rate cuts may not have linear effects on the yield curve as implied here, but this analysis indicates that the Fed will have to cut rates further than in previous cycles to have the same impact on borrowing costs and the housing market. The contrast with the 1990 cycle is particularly concerning as it bears the closest similarity to the current situation, where the downturn was led by housing and the consumer. In response, we are bringing down our forecast for the Fed funds rate to 1.5%, another 75 bps reduction from today's level.

The other related point which comes out of this analysis is simply the length of easing cycles. The last two major easing cycles were in 1990-92 and 2000-03. If we overlay these with the recent experience to date we can see that the current cycle could see the Fed easing well into 2009 and possibly even 2010 (see chart on next page).

The conclusion does not alter significantly if we recast the analysis in real terms. The Fed has cut rates more rapidly in this cycle and has already brought rates down to zero in real terms[2]. This puts it ahead of the last two major cycles where rates took longer to equal inflation. Nonetheless, in the last cycle, rates were below zero in real terms for three years and in the earlier 1990 episode were negative in real terms for nearly two years (chart 5).

Chart 5: Fed rate easing cycles in real terms



Source: Thomson Datastream

Rates lower for longer

Will it be different this time? Bernanke has already cast aside the gradualism of his predecessor and shown a greater willingness to move rates sharply. This suggests he will be quicker to put rates up again when the time comes. We would certainly hope so, as Greenspan's painfully slow, snail-like tightening of policy from 2004 to 2006 undoubtedly contributed to the mess we are in today by keeping rates too low for too long. But whether Bernanke can take away the punch bowl before the party gets going remains to be seen. Our hunch is he will not and we have adjusted our Fed funds forecast to assume that the policy rate remains at 1.5% throughout 2009.

Does this mean we are expecting another policy error a few years down the road? It is already being suggested that today's settings will lead to a pick-up in inflation as indicated by the rise in break-even inflation rates between nominal and index-linked yields.

This is certainly a risk. However, the idea that rates stay very low for a long period is also consistent with past experience of an economy climbing out of a financial crisis. The difficulties facing the Fed in transmitting monetary policy to the economy as described above, which apply to the corporate and real estate sectors as well as household mortgages, mean that it will take longer for activity to pick-up and return to a sustainable upward path. In these circumstances, activity is likely to grow at a below trend rate, thus increasing amounts of spare capacity will be created and inflation will fall rather than rise. In our view the de-leveraging process is just getting underway and the greater risk is to growth rather than inflation – credit crunch rather than stagflation.

[2] The inflation measure used here is core CPI, i.e. inflation excluding food and energy.

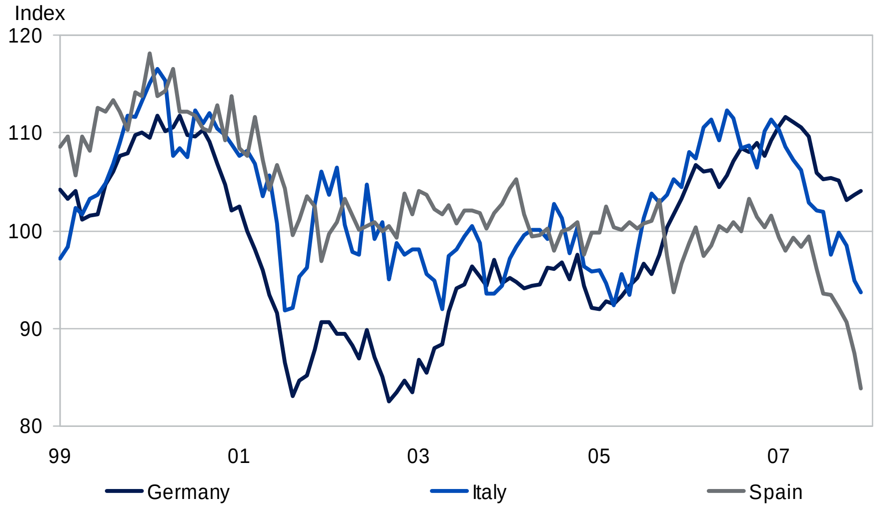
Europe

Growing divergence in Eurozone

A North - South European split

Judging by the recent market response to better manufacturing data from Germany and the Benelux countries, one could be forgiven for thinking that the Eurozone has managed to escape the slowdown that is now engulfing other countries. But there are increasing signs that the regional north-south divergence within the EMU countries is intensifying. While Germany and France are holding up, at least in terms of strong capital goods exports, the Italian economy appears to be close to recession with Spain at risk of a sharp decline, led by housing and the consumer. Key for some southern/periphery countries will be how the housing sector unwinds and its impact on the macro-economy as a whole. This redistribution of growth within the EMU countries heightens the uncertainty about the area wide outlook and complicates policy decisions.

Chart 6: Economic sentiment indices



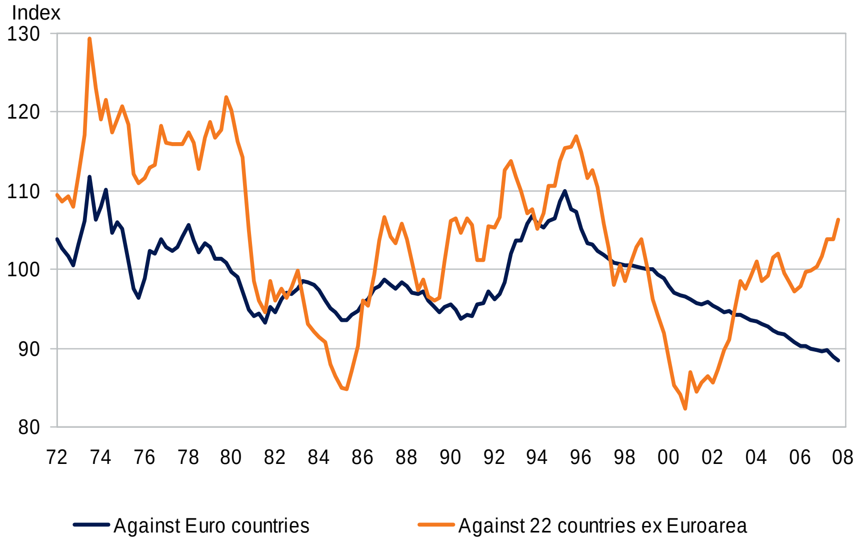
Source: European Commission

Germany's competitive advantage holds

Germany's ability to continue to export despite the strengthening of the Euro is largely down to the relative improvement in its competitive position, as well as strong growth in emerging markets; for instance while Germany's exports to Asian and Eastern European countries account for 25% of its total exports, Spain's exports are 10% with France's share at 15%. Recent data however, shows that exports to China, the US, the UK and Developing countries are already in negative territory when compared to last year. On the other hand, exports to other EMU countries have held up as have those heading to Eastern European countries.

Chart 7 illustrates how Germany's competitive position against other EMU countries has been improving over the past decade and should in all likelihood provide a cushion against a slowdown in exports elsewhere.

Chart 7: Germany losing its export competitiveness against non-Euroarea countries

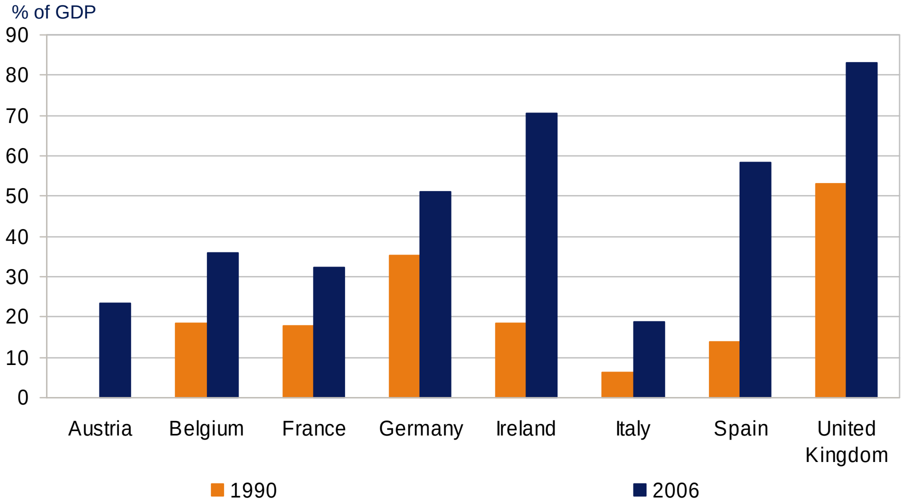


Note: Price competitiveness against EMU countries and 22 non-Euroarea countries.
Source: Bundesbank

But focusing purely on the external position ignores the fact that German domestic conditions are already deteriorating with retail sales growth falling below zero and the ongoing tight financial conditions likely to have a dampening impact on business investment. However, with positive surprises in job creation and modest wage increases, consumption is expected to provide some support to growth.

The divergence of growth within the Eurozone is likely to intensify given that wider credit spreads and tighter lending criteria will impact countries like Ireland and Spain where mortgage debt and personal debt in general have risen quite sharply (see chart 8).

Chart 8: Eurozone & UK mortgage debt

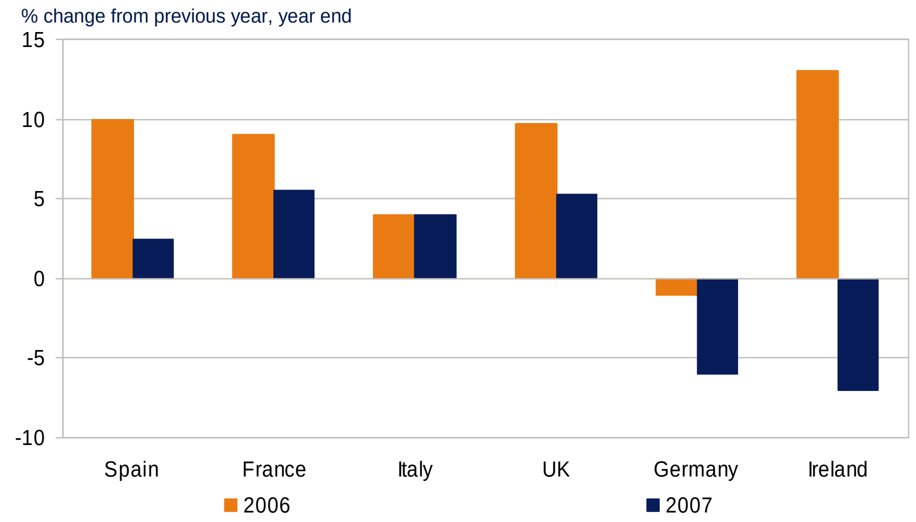


Source: IMF, National Statistics offices

Housing slowdown to impact Ireland and Spain

After experiencing growth rates of 10%-20% in the 5 years leading up to 2006, property price inflation across the Euroarea has dropped significantly in 2007 slowing to just over 5% in a number of countries. In Ireland, the annual increase in house prices is already negative whilst in the UK, recent monthly data show that annual price gains are hovering at just 1% with the six monthly growth rate already showing negative price growth (chart 9).

Chart 9: House Price inflation in Europe, 2006 and 2007



Source: RICS European Housing survey

And there is unlikely to be a near term end to this decline, with mortgage approvals falling by 30% on annual basis in Spain and Ireland; the two countries outside of the UK where the impact is likely to be felt the strongest.

Housing slowdown impacts employment

Job losses likely to follow housing bust

In countries like Spain and Ireland, housing was key to their spectacular growth performance over the past decade. Over this period, both countries enjoyed very strong rates of growth allowing them to catch up with the Eurozone average at an elevated pace. Whereas the Euroarea grew at an average of 2.5% on average since 1998, Ireland recorded an average growth rate of 6.5% while Spain followed with an average of 4%.

In Spain, as in Ireland, the housing boom was accompanied by a massive construction boom; employment in this sector is important because of the large share of construction jobs in both economies compared to the rest of the Eurozone. The chart below illustrates the steady increase in employment since the mid 1990s so that in Spain construction employment accounted for 20% of total employment growth over the period 2003-2006. In Ireland the construction sector accounted for a staggering 33% over the same period, a particularly high figure considering that construction employment has a modest weighting of 12% in both countries.

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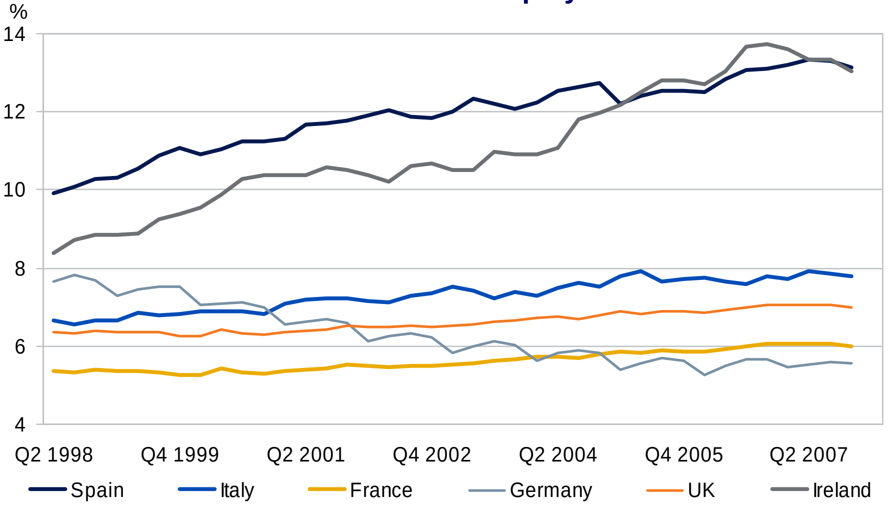
Chart 10: Construction employment share



Source: Thomson Datastream

And the impact on employment is likely to be considerably higher given that housing boosted employment in other sectors linked to the housing boom, such as estate agents and the financial sector. Unemployment in Spain has already picked up with employment expectations over the next 12 months also falling.

UK vulnerable – housing slowdown hits consumption

UK debt & house prices collapse: a toxic mix

Meanwhile, the UK's vulnerability to the credit crisis is made worse because the imbalances of its economy in terms of stretched house valuation, low savings and strains on household balance sheets are so large. The resulting economic downturn feeds back to intensify the financial market crisis as banks then tighten lending criteria.

In effect the UK is more vulnerable to a squeeze in credit because the financial sector is highly deregulated, which allowed for the rapid growth of the non-bank financial sector and securitised finance. This results in a fairly close link between house prices and consumer spending. By contrast, in some continental European countries financial deregulation was slower and less comprehensive so that whereas in the UK the correlation between house prices and consumption is 60% according to the IMF, in France and Ireland it is 10% with a relatively high 40% in Spain. Households' access to housing related financing across Europe depends on different key features of their mortgage markets. Whereas in the UK households are able to withdraw equity from properties, most continental countries are not able to do so, with the exception of Spain and Ireland where access is rather more limited.

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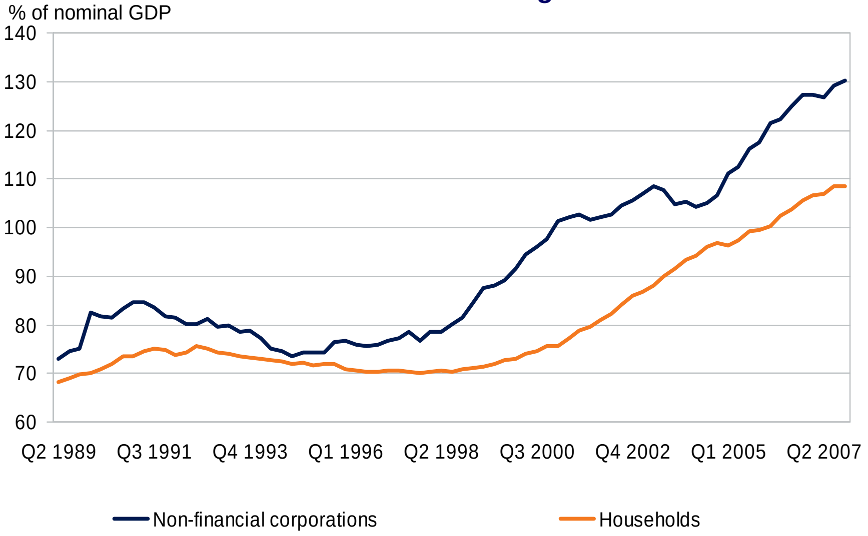
Over the past decade, debt in the UK has been increasing steadily to the point where debt/GDP ratios among households and non-financial companies hit new record highs in Q407. As the chart below shows the household debt ratio now stands at 110% from 70% ten years ago, while non financial companies' debt ratio has jumped to over 130% from 80% over the same period. In fact, combining both sector debt/GDP ratios gives a figure of 230% which according to the ECB places the UK above the EU average of 150% of GDP.

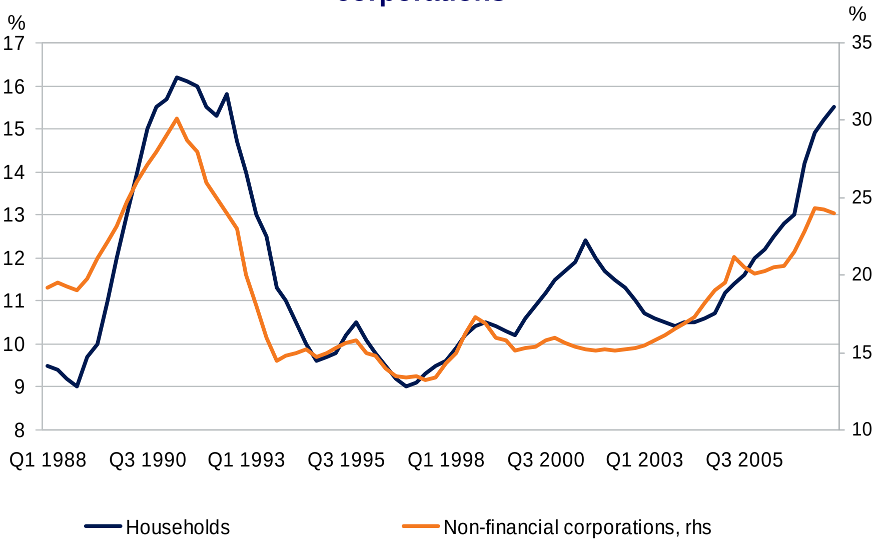
Chart 11: UK Household debt is now the highest in the G7 countries



Source: National Statistics, UK

In terms of debt servicing ratios that is mortgage interest payments plus repayments of mortgage debt as a percentage of income, UK households face increasing costs, and corporations are also close to the previous peak of 16% (chart 12). The latest data point indicates that the debt service ratio is now at the highest level since late 1991, which incidentally followed the bust of the early 90s housing boom.

Chart 12: UK debt servicing ratios for households and non-financial corporations



Source: National Statistics, UK as at 31/12/2007

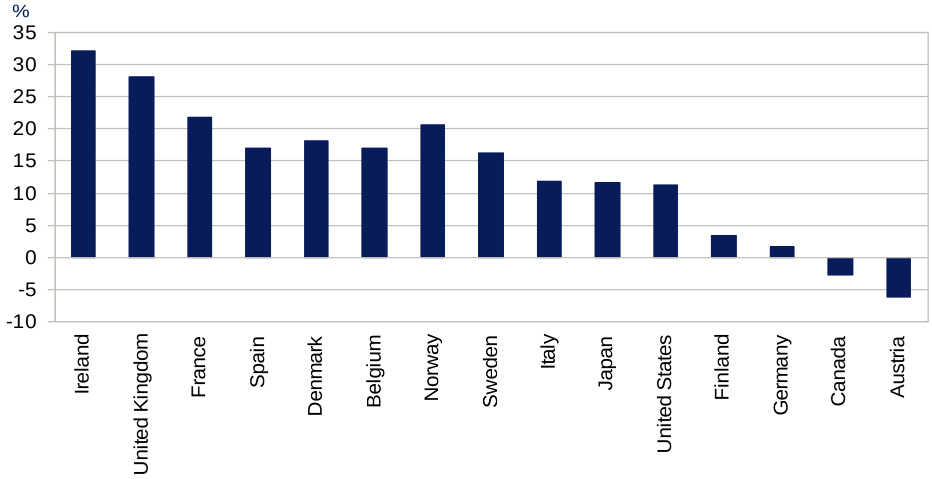
House prices overvalued

How much are house prices overvalued?

According to the IMF's latest World Economic Outlook report house prices are overvalued in 3 EMU countries and the UK. In Ireland and the UK, prices are currently overvalued by 32% and 28% respectively while France follows with 22%. Spanish house prices are 17% overvalued.

In France, the impact on growth from a correction in house price is likely to be limited given the low link to consumer spending – no mortgage equity withdrawal available and no major increase in housing related jobs. The IMF calculates this overvaluation by looking at fundamental factors that drive house prices (long interest rates, short interest rates, credit growth, disposable income, population growth and so on). Any price above the price that would be explained by the fundamentals represents an overvaluation or house price gap, as shown in the chart below. The potential for a sharp drop in the UK and other countries is therefore quite worrying.

Chart 13: House price gaps



Source: National Statistics, UK

Regional summary: An assortment of problems

A variety of problems

Spain's high private sector indebtedness (households and companies) of 180% of GDP implies that spending will likely face an extended period of correction, this year and next. Compared to other EMU countries, banks are tightening lending standards much faster than their counterparts. Residential construction continues to moderate and will also be a drag on overall growth. With a low government debt/GDP ratio the authorities have some room to play with. After the recent March elections, the government announced fiscal expansion measures, including tax rebates and faster implementation of a number of existing public works programmes. These measures should help to offset some of the weakness elsewhere.

Italian economic growth continues to under perform the Eurozone average, as neither exports nor domestic demand took off convincingly in recent years, with subtrend growth recorded every year since 2001 except for a brief spell in late 2006. Export performance deteriorated much more than in France and Spain. Political uncertainty is also affecting business and consumer confidence. Accordingly, public spending cuts have been delayed and there is little room for a fiscal boost given that the slowdown in economic activity will likely take the public deficit close to the 3% limit imposed by the European Council.

In Germany, the strengthening Euro and a slowdown in global demand will act as a stumbling block to growth. In addition to lower export growth, ongoing tight financial conditions will likely have a dampening impact on business investment. But given the ongoing surprises in job creation and rising wages, a modest recovery in private consumption is likely in 2008 and 2009. While recent wage settlements point to a modest pickup in wage growth, there are no signs that the recent significant jump in food and energy prices are leading to inflationary second round effects.

In France, the appreciation of the Euro continues to impact upon the weak external competitiveness of French companies and will in all likelihood lead to stagnation in exports in 2008. In addition, tighter financial conditions are likely to slow domestic demand growth.

Construction spending has already experienced a sharp decline while higher corporate credit spreads point to a moderation in other business spending. Further, the recent moderation in employment and a sharp drop in consumer sentiment points to slow consumption growth. The government will probably boost fiscal spending in order to prevent a sharp slowdown; this is likely to push up the government deficit above the European Commission's budgetary upper limit of 3% in 2008.

In the UK, a scary mix of record high consumer debt, rising debt servicing costs, low saving ratio, falling house prices, falling mortgage equity withdrawal, credit crunch in mortgages and consumer credit, rising taxes, wide current account, incomes easing and unemployment soon to rise, all provide scope for a substantial retrenchment in consumer spending. In addition, tighter lending conditions will reduce business investment with companies already announcing a fall in investment intentions.

Given the fairly poor outlook for UK housing, consumer spending and business investment, we are changing our growth and inflation forecasts for 2008 and 2009. As a consequence, we expect a further 50bp of rate cuts in 2009 so that interest rates end the cycle at 3.75%. For 2008, we keep 4.25% as our year end forecast. UK growth is now expected to be 1.7% for 2008 and 1.4% for 2009.

Tighter credit will force ECB's hand

Conclusion: Eurozone growth divergence is intensifying and this is the situation before tighter credit conditions have fed through into actual lending dynamics. So far, the credit squeeze does not seem to have had a major impact on activity. The chart below, taken from the ECB lending survey undertaken in December of last year and released in early January, showed that a tightening in lending standards had so far impacted modestly upon private sector business investment spending with M&A affected somewhat more. In the meantime, lending to the non-financial private sector continues to grow at close to 15% but this is mostly the result of re-intermediation, as firms' ability to issue debt securities is diminished.

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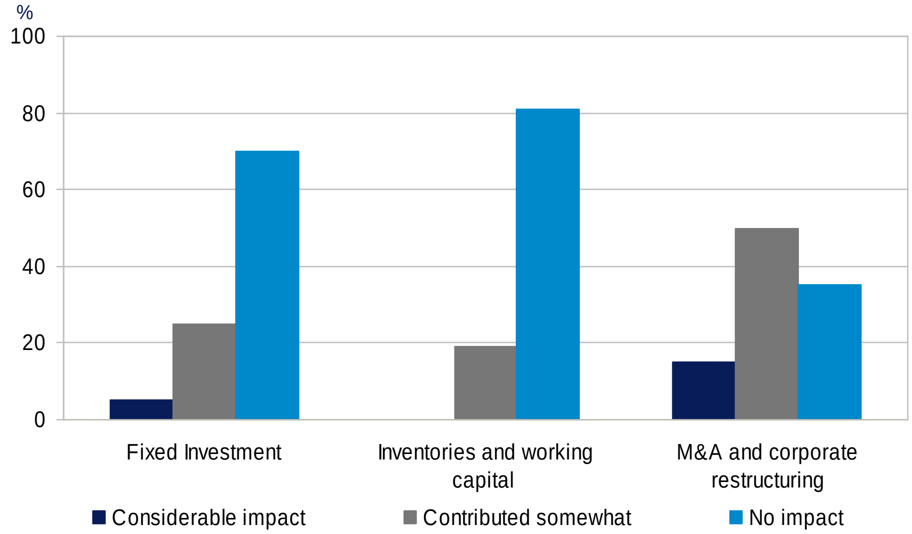
Chart 14: ECB lending survey yet to see impact of credit squeeze on business investment – Early days yet.



Note: Q4 survey was released in early January covering the 2 weeks up to December.
Source: ECB Credit Survey

Given that the last Credit Survey was carried out in late December 2007 and conditions have since deteriorated we would not be surprised to see a noticeable tightening in credit conditions when the survey is next released in the first week of May prompting the ECB to cut soon after. However, in the very near term, high inflation (which we expect to moderate by mid year) and high wage settlements (modest so far) will keep the ECB on a hawkish note.

Euroarea Scorecard = (+or – outlook, from current position)					
	Germany	France	Spain	Italy	UK
Housing	+	-	-	-	-
Consumer	+	-	-	-	-
Exports	+	-	+	-	+
Fiscal boost	-	+	+	-	-
GDP forecast					
2008 (%)	1.6	1.6	2.1	0.8	1.7
2009 (%)	1.9	1.6	2.1	1.4	2.1

Forecast Summary

I. Forecast summary

Real GDP

y/y%	Wt (%)	2007	2008	Consensus	2009	Consensus
US	31.4	**2.2**	**1.4**	1.4	**2.8**	2.3
UK	5.7	**3.0**	**1.7**	1.7	**1.4**	1.9
Eurozone	25.3	**2.6**	**1.6**	1.5	**1.5**	1.8
Japan	10.4	**2.1**	**1.5**	1.3	**1.8**	1.8
Australia	1.8	**4.1**	**3.2**	3.3	**3.5**	3.2
OECD	74.6	**2.4**	**1.6**	**1.5**	**2.1**	**2.1**
China	6.3	**11.4**	**10.8**	10.2	**9.5**	**9.6**
Emerging*	25.4	**7.1**	**7.0**	6.5	**6.5**	6.3
World	100.0	**3.6**	**2.9**	**2.8**	**3.2**	**3.1**

Inflation CPI

y/y%	Wt (%)	2007	2008	Consensus	2009	Consensus
US	31.4	**2.9**	**3.9**	3.2	**1.9**	2.3
UK	5.7	**2.3**	**2.6**	2.5	**2.5**	2.0
Eurozone	25.3	**2.1**	**2.4**	2.7	**1.8**	2.0
Japan	10.4	**0.1**	**0.3**	0.7	**0.6**	0.5
Australia	1.8	**2.3**	**3.0**	3.3	**2.5**	2.8
OECD	74.6	**2.2**	**2.8**	**2.6**	**1.7**	**1.9**
China	6.3	**4.6**	**5.0**	5.0	**4.5**	**3.7**
Emerging*	25.4	**4.9**	**6.0**	6.0	**5.0**	5.0
World	100.0	**2.9**	**3.6**	**3.5**	**2.6**	**2.4**

Interest rates

%	Wt (%)	Dec-07	Dec-08	Market	Dec-09	Market
US	31.4	4.25	**1.50**	**2.52**	**1.50**	3.11
UK	5.7	5.50	**4.25**	**4.90**	**3.75**	4.51
Eurozone	25.3	4.00	**3.50**	**4.21**	**3.50**	3.80
Japan	10.4	0.50	**0.50**	**0.72**	**1.00**	0.84
OECD	72.8	**3.73**	**2.27**	**3.04**	**2.30**	3.14

Market from forward futures strip as at 15/04/2008

Key variables

FX	*Current*	Dec-07	Dec-08	y/y%	Dec-09	y/y%
USD/ GBP	*1.96*	2.01	**1.94**	**-3.7**	**1.85**	-4.6
USD/ EUR	*1.58*	1.46	**1.60**	**10.0**	**1.50**	-6.3
JPY/ USD	*101.9*	112.48	**95.00**	**-15.5**	**100.0**	5.3
GBP/ EUR	*0.80*	0.72	**0.82**	**14.2**	**0.81**	-1.7
Brent crude	*111.5*	88.8	**105.0**	**18.3**	**100.0**	-4.8
US output gap %GDP	*-0.2*	0.0	**-1.1**		**-0.8**	
Unemploy. %	*4.9*	4.8	**5.4**		**5.6**	

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

* **Emerging**: 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 2006 US$)

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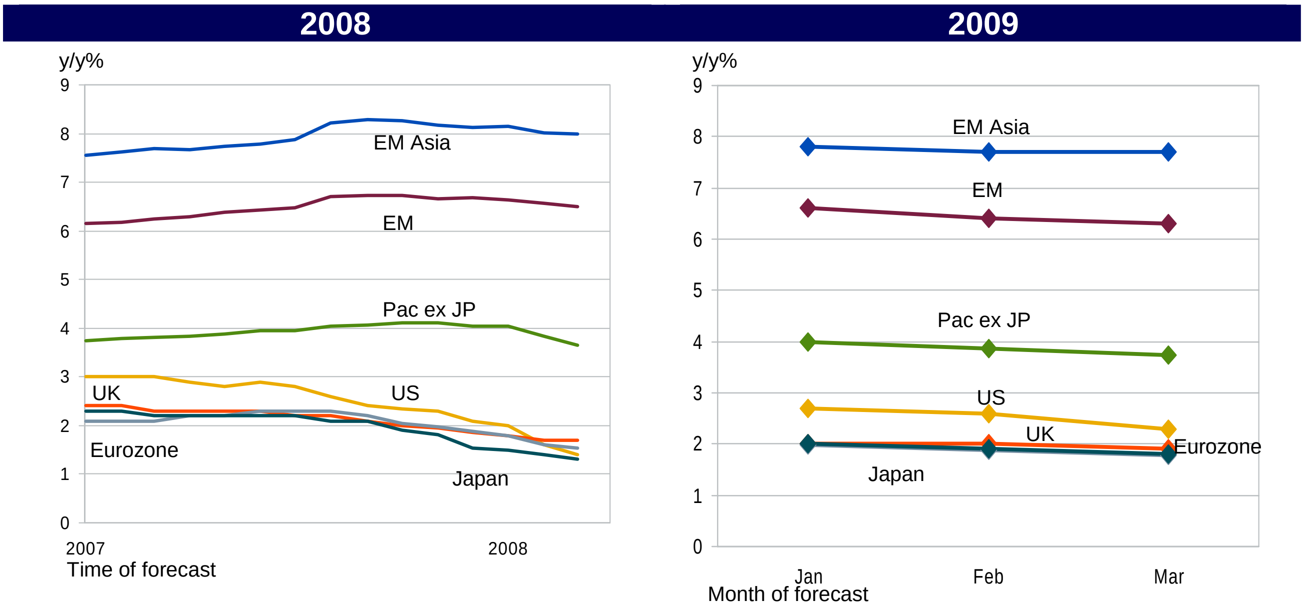
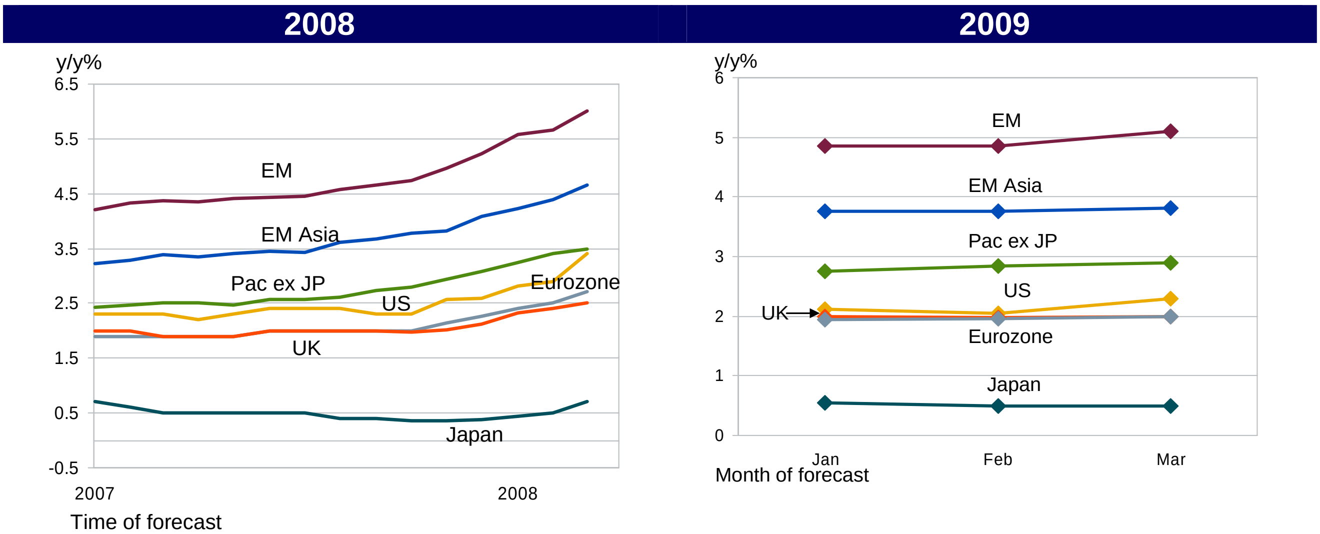
II. Updated forecast charts

Chart 1: GDP forecasts



Source: Consensus Economics (Mar.), 2006 GDP weights, 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, Slovakia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovenia

Chart 2: Inflation forecasts



Source: Consensus Economics (Mar.), 2006 GDP weights, 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, Slovakia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania, Slovenia

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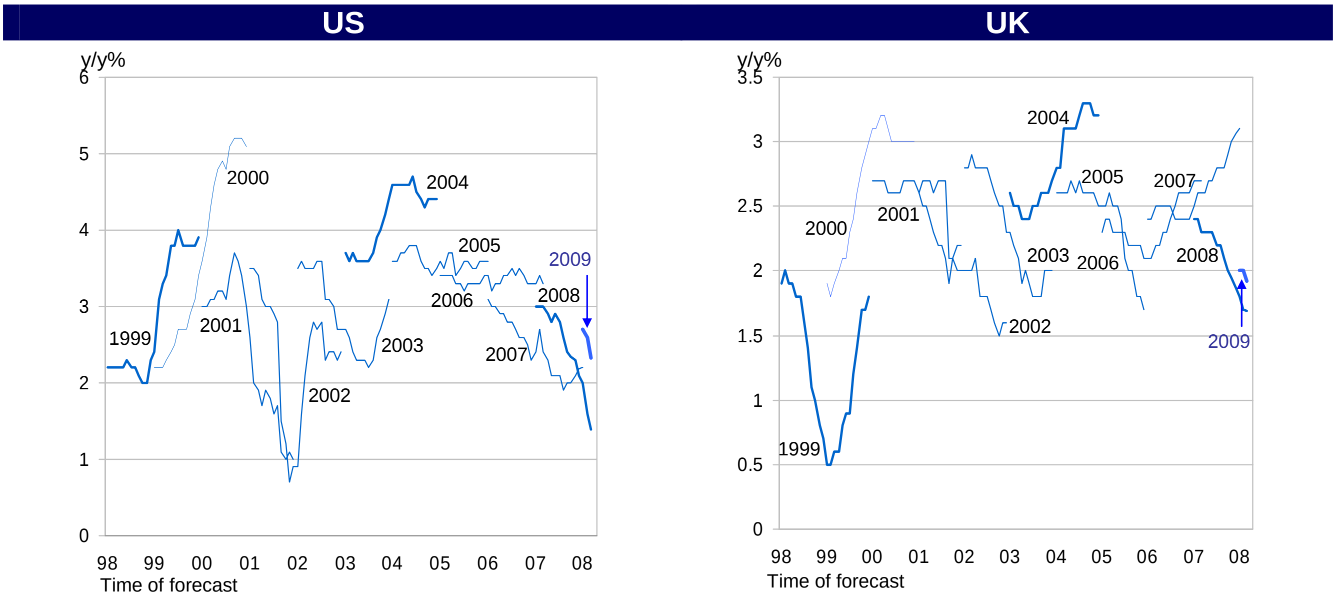
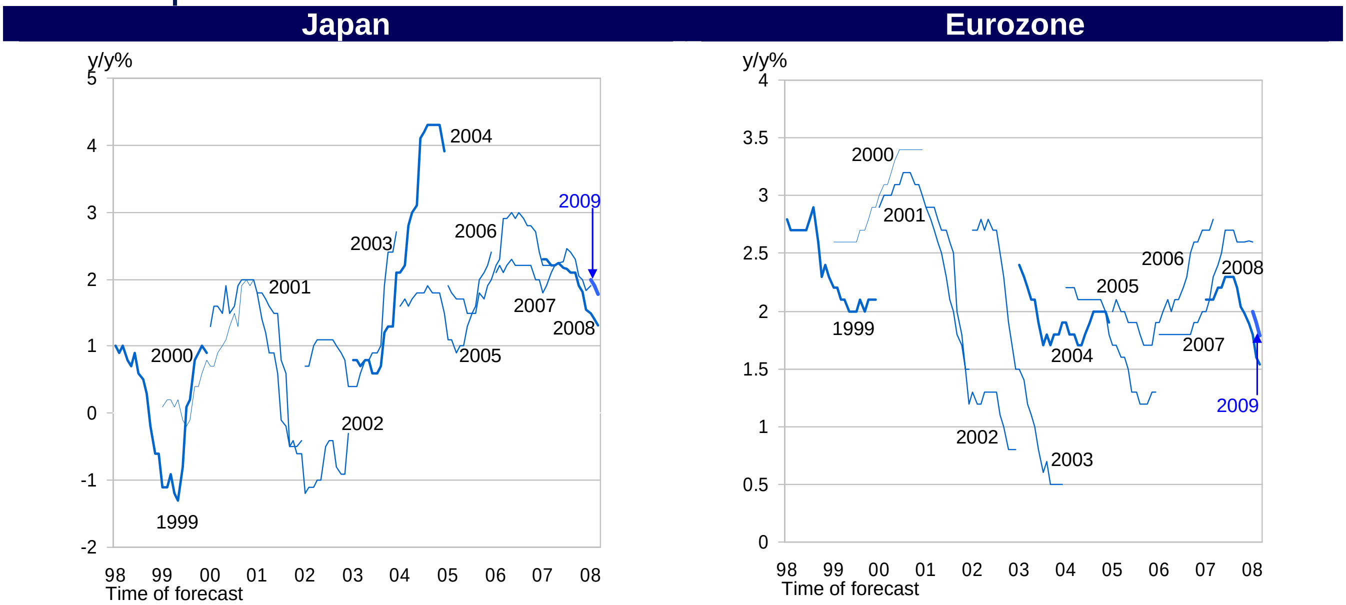
Chart 3: US and UK GDP forecasts



Source: Consensus Economics (Mar.), Schroders

Chart 4: Japan and Eurozone GDP forecasts



Source: Consensus Economics (Mar.), Schroders

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