

# Schroders

## Economics and Strategy Viewpoint

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### Global: Inflation fears run rife (page 2)

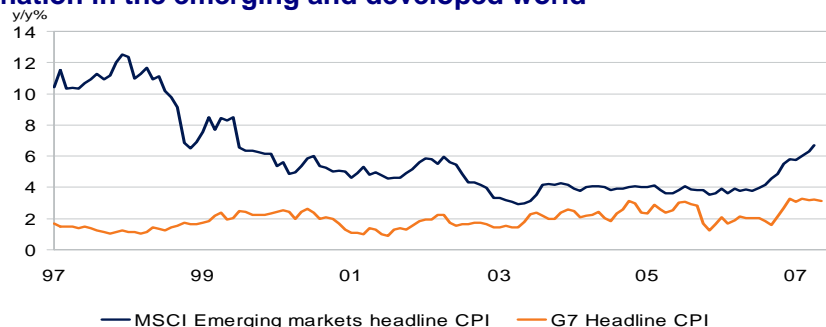
- The credit crunch seems to be yesterday's news, central banks and markets are now grappling with the consequences of the surge in commodity prices. Policy makers have kept up the hawkish rhetoric and markets now fear a rise in global interest rates.
- However, whilst recognising the danger of all central banks blaming higher inflation on external factors, we do not see the need for a tightening of policy in the OECD. In our opinion, monetary policy is already tight in the major economies judging from the behaviour of surveys, market rates and credit growth.
- The problem primarily lies with the emerging economies who, through their ties to the US dollar, are setting policy in line with the collapsing US housing market at a time when they are experiencing strong growth. Unless activity is reined in, overheating will be the inevitable consequence.
- Should the US move into a stagflationary environment our analysis suggests that cash and commodities are the best asset class while both equities and bonds would suffer (page 6).

### Europe: Rising labour costs worry the ECB (page 8)

- UK CPI has triggered a letter from the BoE governor to the Chancellor. Higher utility bills could lift CPI to 4.5% by Q3. This is likely to prompt a further 4 letters from the BoE over the next 12 months. At the same time the UK's economic picture continues to deteriorate.
- Strong UK retail sales are puzzling and run counter to evidence elsewhere. BoE rhetoric is turning hawkish but mixed messages indicate that the Bank is reluctant to hike rates. We suspect that the tougher rhetoric is intended to discourage higher wage setting.
- The ECB has sent a strong signal that it will be hiking interest rates in July. We expect a 25bp increase. The main reason for this action is for the ECB to send a strong signal to wage setters.
- Labour costs in the Eurozone are rising, largely in Spain. Wages could rise further in coming quarters but will feed into lower margins rather than into spiralling inflation. We expect the ECB to cut rates, by 50bp, in 2009 rather than this year.

### Forecast summary (page 15)

#### Inflation in the emerging and developed world



Source: Thomson Datastream, Schroders



# Global

## Inflation fears run rife

*"The risk is that prices for food and raw materials will continue to rise. If every central banker decided that this is a problem for other countries, nobody will do anything and there will be (faster) worldwide inflation"*

Brazil's Central Bank President Henrique Meirelles, 18th June, 2008

## Inflation hits multi-year highs

The impact of the credit crunch on the economy would seem to be yesterday's story as markets grapple with the consequences of rising commodity prices on inflation. Headline inflation rates continue to rise with the CPI above 4% in the US, reaching its highest level for 16 years in the Eurozone at 3.7% and in the UK hitting 3.3%, thus causing the Governor of the BoE to pen a letter to the Chancellor. In the emerging world, the increase has been even more dramatic with inflation running at close to 8% in India and China.

## Is policy too loose?

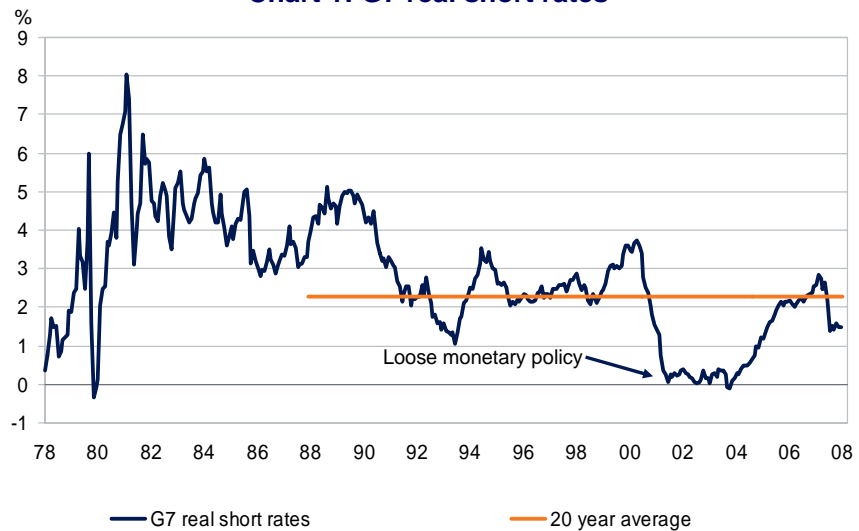
Food forms a bigger part of the consumption basket in the emerging economies and consequently has had a greater impact on inflation. For example, in India and China food accounts for 47% and 33% of the CPI basket respectively compared to 14% in the US. Nonetheless, the inflation problem in these economies would appear to be more entrenched with core rates (i.e. CPI ex.food and energy) also accelerating. This is in contrast with the higher income OECD economies where without commodity price increases inflation would be stable.

Nonetheless, it has to be acknowledged that the world as a whole cannot import inflation. As Mr Meirelles makes clear, if each individual central bank blames higher inflation on forces outside their control then the result will be a monetary policy which is too loose. If there were a single global central bank with a single currency it would be tightening policy today. Recognition of this may well be the reason for the chorus of hawkish rhetoric emanating from the US and European central banks in recent weeks.

Given that we do not (as yet) live in a world of a single central bank the natural question must be where is monetary policy too loose? The most frequently quoted measure of the tightness of monetary policy is the real interest rate: the current interest rate minus headline inflation. On this measure policy seems loose. The Fed funds rate is below inflation in the US (a negative real rate), it is close to zero in Euroland and just under 2% in the UK. Even Japan now has a negative real rate.

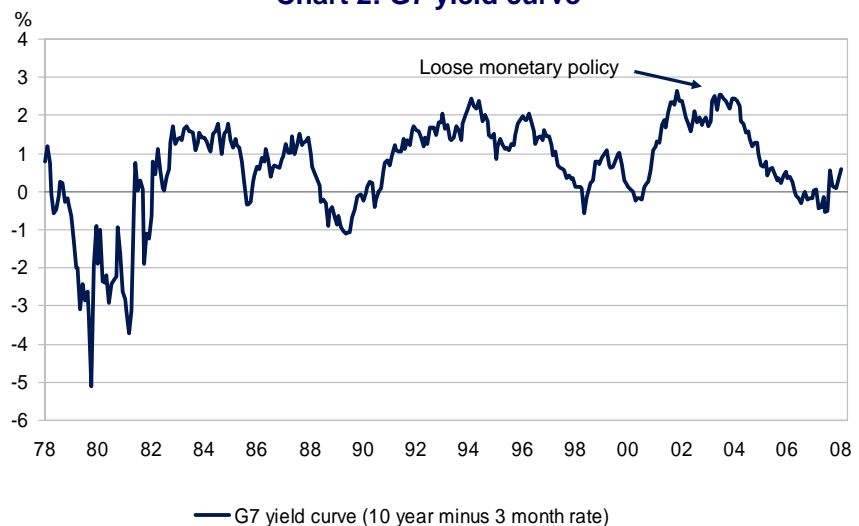
However, judging the stance of policy is more art than science and other measures of policy are certainly not loose. For example, calculating real interest rates using core rather than headline inflation suggests policy in the G7 may be easier than a year ago, but it is a long way from the very loose policy of 2002-04 when real rates averaged zero. Core is used rather than headline CPI as it is believed to be a better long term measure of inflation expectations. This may be questioned in the current environment, but unless commodity prices continue to accelerate, their impact on headline CPI will fade. The G7 yield curve gives a similar message: the curve has steepened recently but is still relatively flat by historic standards (see charts 1 & 2).

**Chart 1: G7 real short rates**



Note: G7 real short rates are GDP-weighted for countries: US, UK, Germany, Japan, France, Italy and Canada. Inflation is G7 core CPI  
 Source: Thomson Datastream, Schroders

**Chart 2: G7 yield curve**

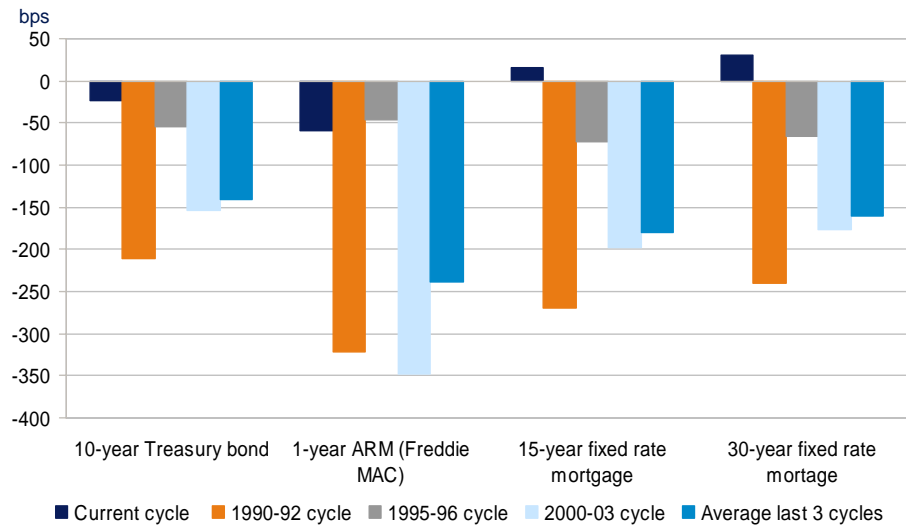


Note: G7 10 year bond yields and 3 month short rates are GDP-weighted for countries: US, UK, Germany, Japan, France, Italy and Canada.  
 Source: Thomson Datastream, Schroders

***The cost of credit has risen for many borrowers***

The case for policy being closer to tight than loose is supported by other indicators such as surveys of bank lending policies (which remain tight in the US and Europe), slowing growth in household credit and the continuing wide level of credit spreads in those securities markets which are still functioning. It may be yesterday’s story, but the credit crunch is still an influence on the policy transmission mechanism and hence the outlook. For example, the latest sell off in bonds combined with credit concerns means that fixed rate mortgages are actually more expensive today than when the Fed started cutting the funds rate last September.

**Chart 3: Response of bond yields and mortgage rates to 100bps Fed easing**



Source: Thomson Datastream, Schroders

**Source of loose global money can be found outside OECD**

If policy is not loose in the developed world then the source of easy policy must be elsewhere i.e. in the Emerging markets. Monetary policy in many of these economies is driven by links to the US dollar and given the inflation backdrop, real interest rates have fallen sharply and are low (chart 4). Other indicators such as credit growth support the view that policy is too loose in the emerging world.

**Chart 4: Monetary policy in the emerging world**



Source: Schroders

As we have argued before, there is a mismatch between policy and real activity in many of the emerging economies which can be seen in their overheating problems. Given that we may not see much progress on changing the policy stance in the emerging world this suggests the problem could get worse in coming months.

From the OECD perspective an implication is that policy needs to be tighter than otherwise to bring inflation under control. This is part of the thinking behind the *End of the NICE* (Non Inflationary Constant Expansion) decade featured in last month's Viewpoint, where we asked whether the trade-off between growth and inflation may have deteriorated. Our view remains that inflation will improve in the OECD, but it is predicated on there being an extended period of slow growth to create the slack needed to cool prices.

**Market impact**

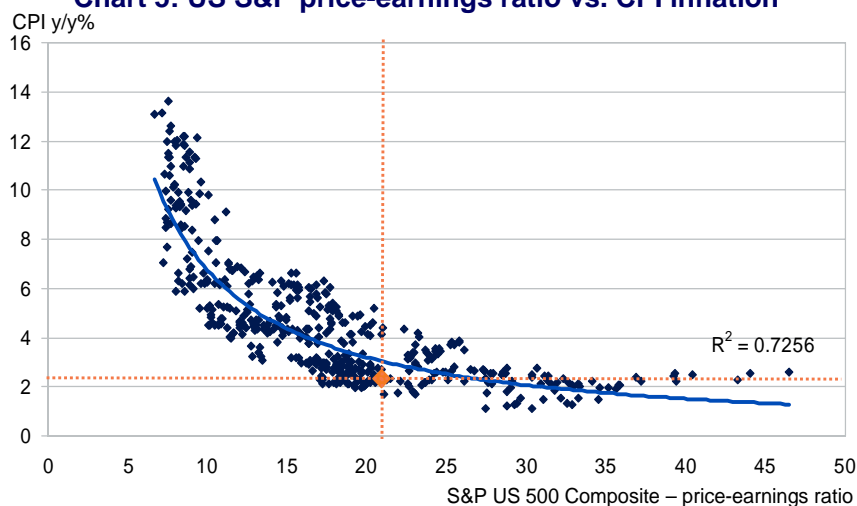
**Stagflation hits both equity and bond markets**

*Putting the inflation debate to one side, the following section looks at the effect of inflation, or more precisely stagflation, on markets.*

As can be seen from the recent performance of equity and bond markets, inflation is not good for your wealth. Fears that higher inflation will mean both a tighter monetary policy and weaker activity tend to hit both equity and bond markets. Essentially, higher inflation causes a de-rating of equity markets while higher price expectations push up nominal bond yields.

The inverse relationship between inflation and equity market PE's highlights the de-rating effect (see chart 5). The current trailing PE on the S&P500 is not out of line with current inflation, but note that the line of best fit is non-linear highlighting the damage that high inflation rates can do to equities.

**Chart 5: US S&P price-earnings ratio vs. CPI inflation**



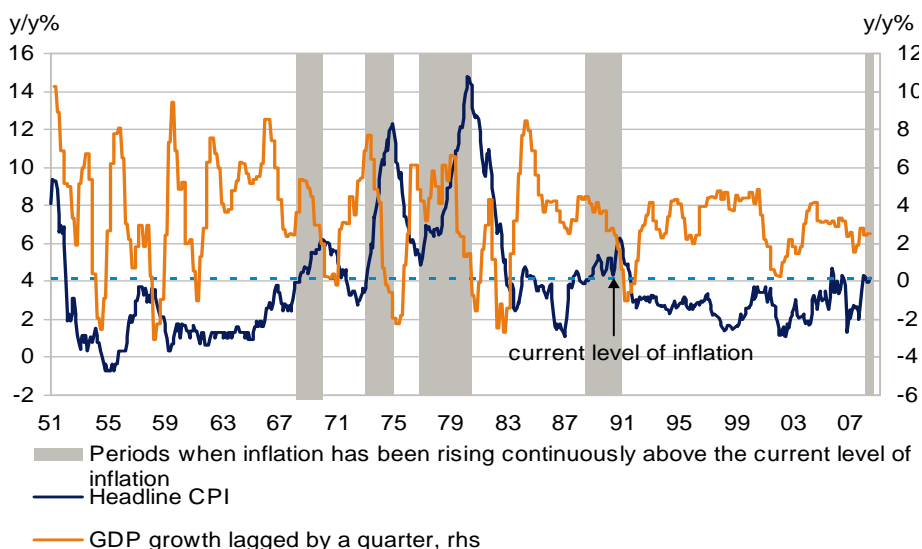
Source: Thomson Datastream, Schroders



### Performance of assets under stagflation

By way of an historical comparison, we looked at four periods in the US where inflation accelerated and growth fell – the sort of stagflationary environment which markets fear today. We focused on situations where inflation was running close to current levels of 4%, before accelerating. The most pronounced of these episodes was in the 1970s when inflation rose to double digit levels and growth slumped. However, we also include the periods from the late 1960s and late 1980s which saw a pronounced pick up in headline CPI (see chart 6). The average length of these phases was around 2½ years, indicating that were we to see something similar its effects would be with us until well into 2010.

**Chart 6: Headline CPI and growth in GDP in the US**



Source: Thomson Datastream, Schroders

**Table 1: Market performance during rising inflation**

Periods of rising inflation	Duration (yrs)	% change in			% annualised market performance				
		Inflation (y/y)	Interest rates	GDP (y/y)	Equity	Bonds	Cash	Commodity	Inflation
04/1968 - 12/1969	1.7	2.3	3.1	-1.6	5.6	-0.5	6.3	n/a	5.6
02/1973 - 12/1974	1.8	8.5	1.3	-8.8	-20.2	4.3	8.0	58.0	10.9
11/1976 - 06/1980	3.6	9.5	6.5	-5.6	8.7	2.5	8.4	22.3	10.4
06/1988 - 11/1990	2.4	2.3	0.3	-2.8	10.6	10.1	8.1	35.0	5.3
<b>Average</b>	<b>2.4</b>	<b>5.6</b>	<b>2.8</b>	<b>-4.7</b>	<b>1.2</b>	<b>4.1</b>	<b>7.7</b>	<b>38.4</b>	<b>8.1</b>

Data: US S&P 500 TR index, US 10 yr govt. bonds TR, US 3M T-Bill TR, S&P GSCI commodity TR index (1951 - 2008). The grey shaded cells imply the asset outperforms cash.

Source: Schroders, Datastream

**Sell equities and bonds, buy commodities**

Although this is a small sample, market performance was consistent during these episodes. On average, equity and bonds both underperformed cash and inflation. By contrast, commodities enjoyed strong real returns (see table 1). Looking at the individual periods, equities did beat cash on two occasions, but only with any significance in the latter 1988-90 episode and not in risk adjusted terms. On this analysis, cash and commodities are the best assets to hold in a stagflation environment.

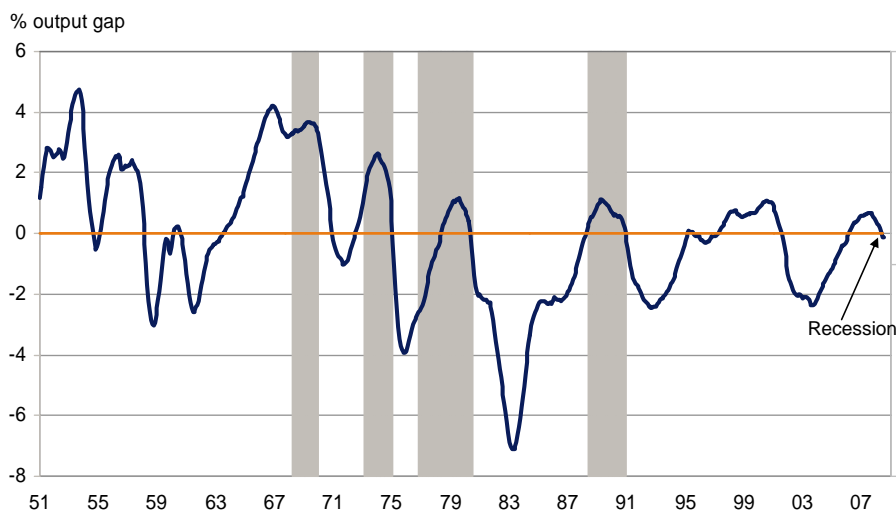


### Comparison with today

In thinking about the current situation there are parallels with each of these episodes, particularly the presence of commodity price shocks. However, as we argued last month, the greater flexibility of labour markets and credibility of monetary policy in the US (and OECD) should prevent a return to the 1970s (or any of these episodes).

One factor which reinforces this view is that the US is at a very different stage in its economic cycle. In each of our four stagflationary episodes the US economy was operating above its long run trend: capacity utilisation rates were high and the labour market was tight. These are the ideal conditions for inflation to develop. In terms of our asset allocation framework, we were in the slowdown and expansion phases of the cycle. The difference with today is that on our estimates, the US has moved below trend as spare capacity opens up in the labour market. It would be very unusual to experience stagflation in these circumstances. Rising unemployment should limit workers ability to achieve inflation busting wage gains while lower capacity utilisation rates indicate that pricing power should be weak.

**Chart 7: US output gap**



Note: Shaded areas are stagflation episodes.  
Source: Schroders

The continued stability of core inflation in the G7, the absence of second-round effects on wages and the prospect of higher unemployment underpins our view that inflation fears will ultimately prove unfounded. However, given the powerful base effect of an oil price at \$135 per barrel, we will be living with elevated headline inflation for most of the summer, at best. Stagflation will not be going away soon.

# Europe

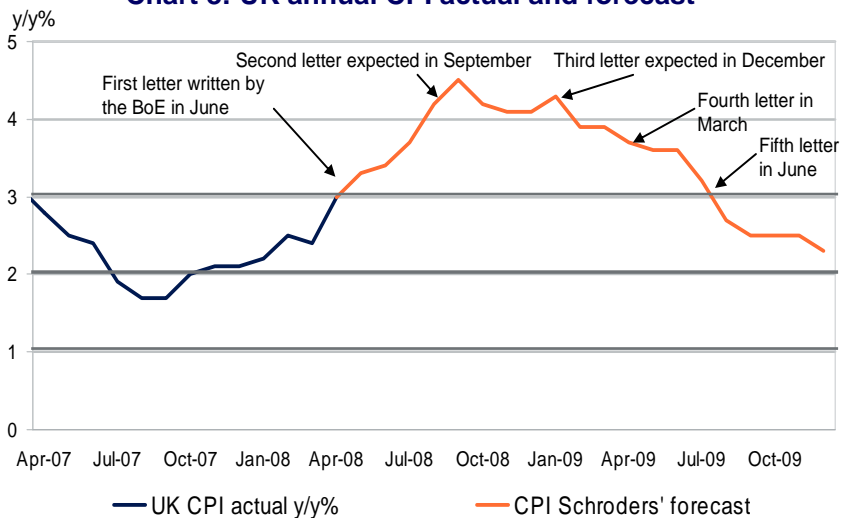
## BoE dilemma continues as inflation peaks higher

### *BoE King to pen more letters to the Chancellor*

Everyone has gone hawkish, or so it seems judging by central bank comments and recent market pricing. In just over a month, market expectations for unchanged or rate cuts at the ECB and BoE respectively have taken an about turn with hikes now expected before the year is out. Market attention has shifted away from weak growth to inflation. The CPI has now risen beyond the permitted 1% band above the 2% inflation target. According to the Bank's remit, it must write a letter of explanation every 3 months while the CPI remains above 3%. Given our inflation profile the BoE Governor could be writing a further 4 letters in coming months in addition to this month's letter (chart 8).

But it is the further increase in wholesale gas prices has led us to revise up our inflation forecasts for 2008 and to push out any likelihood of a near term reduction in interest rates. We now expect November to be the earliest possible time the BoE could consider cutting rates. Whereas previously we had inflation topping 3.6% in September, the peak is now likely to be closer to 4.5% and that is assuming a 20% increase in utility bills. Under this scenario inflation returns to target by the end of 2009. If however we assume a 40% hike in utility bills as touted by Centrica, the owner of British Gas, then we could be looking at 5% plus inflation rates in the near term.

**Chart 8: UK annual CPI actual and forecast**



Source: Thomson Datastream, Schrodgers

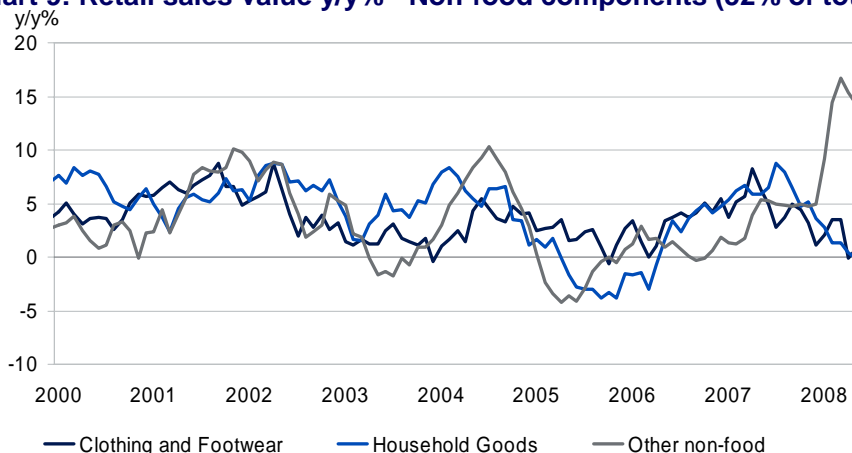
Centrica has a 50% share of the domestic gas market and 25% of the electricity market and any actual increases in bills would surely be followed by other providers. As we highlighted in May, higher utility bills are an inflation threat following the 160% increase in wholesale gas prices since June of last year.

**Outlook continues to deteriorate**

At the same time the UK's economic picture continues to deteriorate. The fundamental problems which we have mentioned in past issues of the Viewpoint remain very relevant, namely the build up of household debt, plunging house prices, tighter lending by banks and expensive credit. The latest BoE survey carried out by its agents across the country shows a consistent picture of weakness, be it in consumer spending, business services, construction, manufacturing, employment and investment.

But the weakness in the data is not all one way. Retail sales for May showed a monster 3.5% month on month increase that was the highest monthly gain since June 1979 (when volumes surged 6.8% month on month). This strength in consumer spending is puzzling and runs counter to reports from many retailers who suggest that sales growth has slowed sharply. It also contrasts with our core view that the UK consumer is likely to experience a sharp slowdown.

**Chart 9: Retail sales value y/y% - Non-food components (52% of total)**



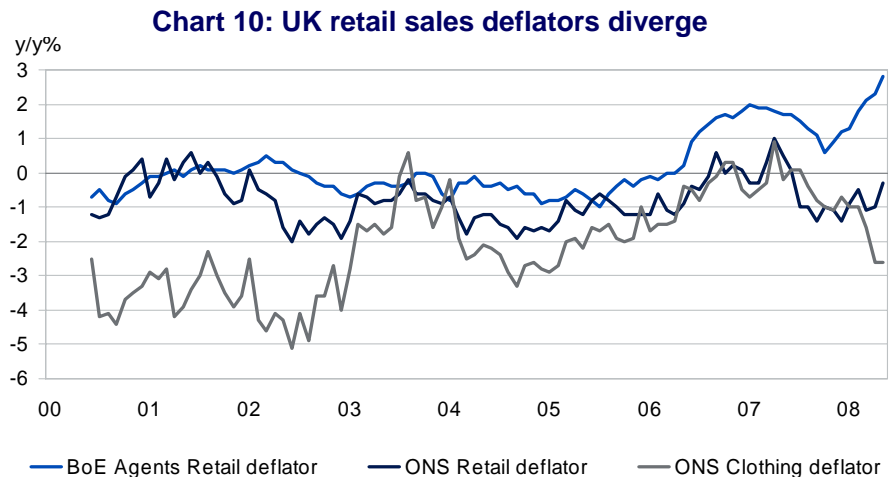
Source: Thomson Datastream

**Strong retail sales run counter to evidence elsewhere**

The ONS, the UK's official statistics office, noted that the surge in the volume of retail sales was driven largely by the "textile, clothing and footwear" component as a result of better weather. The previous month's figure was also distorted by the release of a video game, recorded under the "other non-food" category. This month, consumers were apparently delaying purchases of summer clothes until the weather justified it. Sales in this category surged by 9.2% in one month jump compared to an average of 0.5% for the past 15 years. So it is likely that this month's number is an outlier.

But the weather is likely to provide only a partial explanation. Most likely, it is due to heavy discounting in the clothing and footwear sector, with issues also raised about the reliability of the deflator used to calculate volumes of sales in this category. The chart below shows the extent of discounting as recorded in the official Clothing and footwear deflator, running at -2.3%yoy with the total retail sales deflator also negative. But note that this series contrasts with the BoE agents survey of retail sales prices, which shows a pick up high street inflation. Perhaps, the ONS figures are overstating the extent of price discounting.

### **BoE unsure of official retail sales data**



Source: UK National Statistics Office, Bank of England

But what counts from a policy point of view is what the BoE makes of the data. The MPC has in recent comments said that they suspect the ONS retail sales data may be exaggerating the actual trend in sales growth. The latest minutes of the June MPC meeting stated that “Survey data from the British Retail Consortium and the CBI reported much weaker growth in sales. So it seemed sensible to place more weight than normal on these indicators relative to the official data in assessing the current state of consumer demand.”

Nevertheless, given the current climate of higher interest rates expectations, stronger data will be looked at closely. We do not think that market expectations of a rate hike are correct and take comfort from the BoE governor’s comments in the letter to the Chancellor “The Committee believes that, if Bank Rate were set to bring inflation back to the target within the next 12 months, the result would be unnecessary volatility in output and employment. So the MPC is aiming to return inflation to the 2% target within its normal forecast horizon of around two years”. Suggesting they are looking beyond the near term.

But given elevated readings for inflation expectations – whether measured among the general public, businesses or derived from financial markets we are also aware of MPC comments to the effect that “... there should be no doubt that the MPC is prepared to take whatever action is needed to return inflation to the 2% target and to keep expectations of inflation in the medium term anchored to the target.”

In sum, if anything the rhetoric is turning hawkish but the mixed message in a way indicates that the Bank is reluctant to hike rates. We think that what is important to the BoE is whether the temporary hump in inflation and rising inflation expectations translate into higher wage demands and suspect that the tougher rhetoric is intended to discourage higher wage setting.

### **Mixed BoE message shows reluctance to hike**

In that respect, the recent deterioration in the labour market will help. In the three months to April the unemployment rate has started to increase, rising from a cycle low of 5.2% to 5.3%. This softening trend, if continued, should act as a restraint on the ability of labour to succeed in gaining higher wage demands to compensate for rising inflation.

***UK earnings easing;  
unemployment rising***

Earnings growth is also easing, both including and excluding bonuses. The breakdown of earnings growth by sector also provides reasons for optimism. The key feature over the past year is the contrast between accelerating service sector earnings and decelerating manufacturing sector earnings. But that gap is unlikely to last. The June service sector PMI reported a plunge in the employment index from 51.0 to 46.5 and while that drop might exaggerate the speed of decline in job prospects in that sector it is a very credible signal of the changes that are taking place in the finance sector in particular in response to the credit crisis. The implication is that the upturn in the pace of service sector earnings growth will soon be reversed.

All these factors argue against the ability of UK wage earners to respond to the surge in inflation and inflation expectations by gaining higher wage deals. Further, the response of employers to the huge hit to margins from higher commodity input costs will be to try to economise on other input costs, and that will mean labour losses.

Of course, while all the talk focuses on inflation, the market appears to forget that the outlook for growth is likely to be very weak, especially if the BoE does not respond with near term interest rate cuts. As house prices continue to slide, consumer spending will be reduced. The link between house prices and consumer spending in the UK is the closest among major industrial countries. The same factors that are hitting housing (high debt levels, reduced credit availability) will hit consumer spending, with this link magnified by wealth effects; falling house prices will curb equity withdrawal and push households into negative equity. The weakness in housing is a precursor of the sharp slowdown in domestic demand across the economy as a whole.

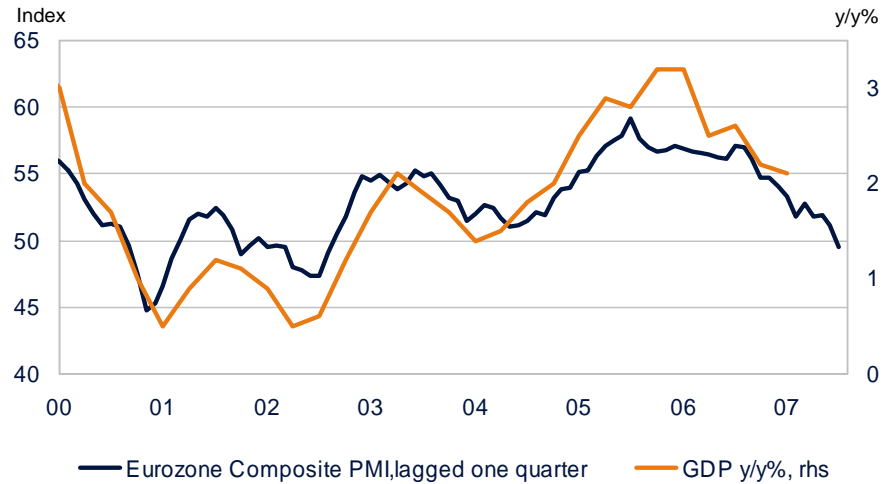
**Rising labour costs worry the ECB*****ECB to hike in July***

Turning to the Eurozone, we have reluctantly changed our forecast for interest rates following the strong hints given at the June meeting earlier in the month. While Mr Trichet's comments during the press conference were somewhat ambiguous, "we could move our rates at the next meeting" and "a rate move by a small amount is possible not certain" we believe that for the ECB to make such strong comments and not follow through would risk severely damaging their inflation fighting credibility. Subsequent comments by ECB members have sought to play down a series of rate hikes but have not tried to dismiss a July hike.

The problem for the ECB is that while inflation continues to rise, reaching 3.7% - the highest in 16 years - the outlook for growth continues to deteriorate. By contrast the ECB expects that the Eurozone economy is robust and that growth will pick up in the second half of this year. The recently released PMI indices, shown in the chart below, highlight that growth is unlikely to be recovering any time soon. And while talk is of rate hikes for the time being, we think that the market will soon scale back expectations for a further couple of rate hikes this year, as inflation peaks in the next 2 to 3 months. Talk will soon turn to rate cuts. We now expect the ECB to cut rates, by 50bp, in 2009 rather than this year via a 25bp hike in July.

**...but outlook not as robust as the ECB thinks**

**Chart 11: PMIs point to slowing growth – What will the ECB do next?**



Source: Bloomberg

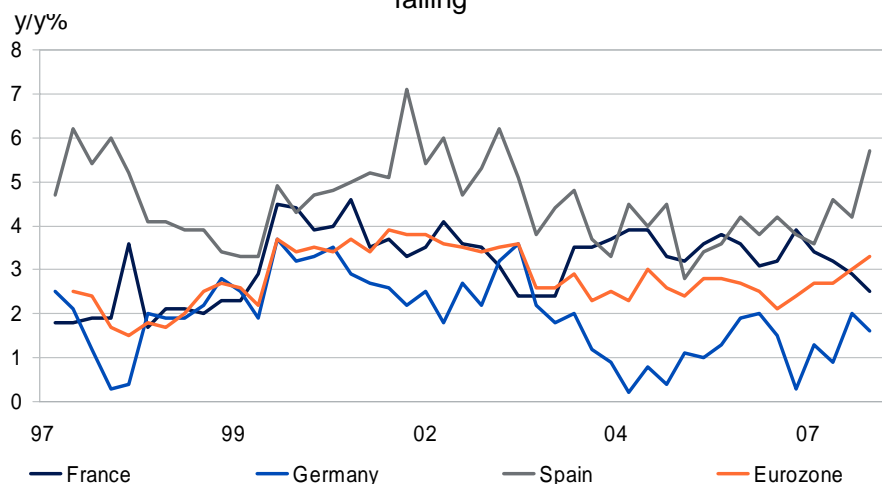
**Labour costs rise**

The main reason for the July hike would appear to be for the ECB to send a strong signal to wage setters that they will not tolerate second round effects - but is also an opportunity for the Bank to gain their inflation fighting credentials. Mr Trichet strongly underlined that spot inflation is not the issue but stated they are concerned with anchoring expectations.

The recent increase in labour costs therefore could be what's troubling the ECB. Q1 data showed a sharp pick up in wages, but it is interesting to note that while France and Germany reported a drop, Spain experienced a sharp increase, lifting the Eurozone total to 3.3% from 2.9%.

**Chart 12: Eurozone wage growth picks up**

Driven up by Spain – wages in Germany and France are contained or falling



Source: Thomson Datastream

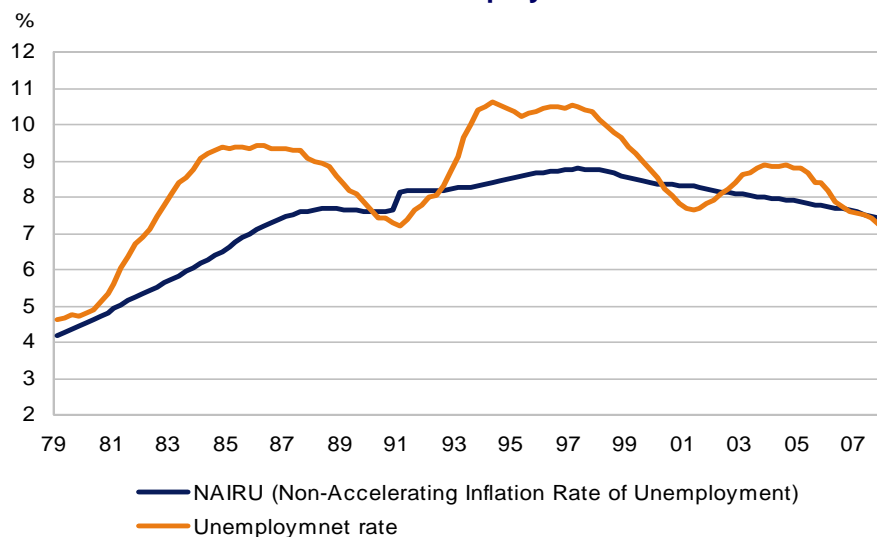
**Wage indexation a worry**

The reason behind this is primarily wage indexation. Wage indexation mechanisms have been reduced since the 1970s but a few countries still hold on to the practice, namely Spain and Belgium. Here, a large majority of private sector wage deals benefit from regular indexations occurring at fixed and relatively short intervals of times which makes any shock in prices spread very rapidly into wages. In France indexation takes place via adjustments to the minimum wage which normally occurs in July each year or earlier if core CPI exceeds 2% (currently 3.3%). The minimum wage was increased by 2.3% in May (for the first time since 1996) and while the minimum wage affects only around 10% of the workforce the knock on effect could lift other wages. There is no indexation scheme in Germany where wages are reviewed annually through negotiations headed by trade unions at the industry level. The basis of negotiation does not include an inflation clause but this is obviously a factor that can influence claims in periods of inflationary shock.

**Labour market beginning to deteriorate**

And labour market conditions remain relatively tight. Unemployment in the Euroarea has been falling for a number of years and that decline has pushed the unemployment rate to its lowest level since 1992. At 7.1%, it is below the estimated NAIRU (OECD) and not surprisingly wages, have responded. However, the labour market has seen recent sharp increases in unemployment in Spain, Italy and now even Germany. Nevertheless, while labour market prospects are beginning to deteriorate, the expected slowdown will take time before significantly easing labour market conditions.

**Chart 13: Eurozone unemployment below NAIRU**



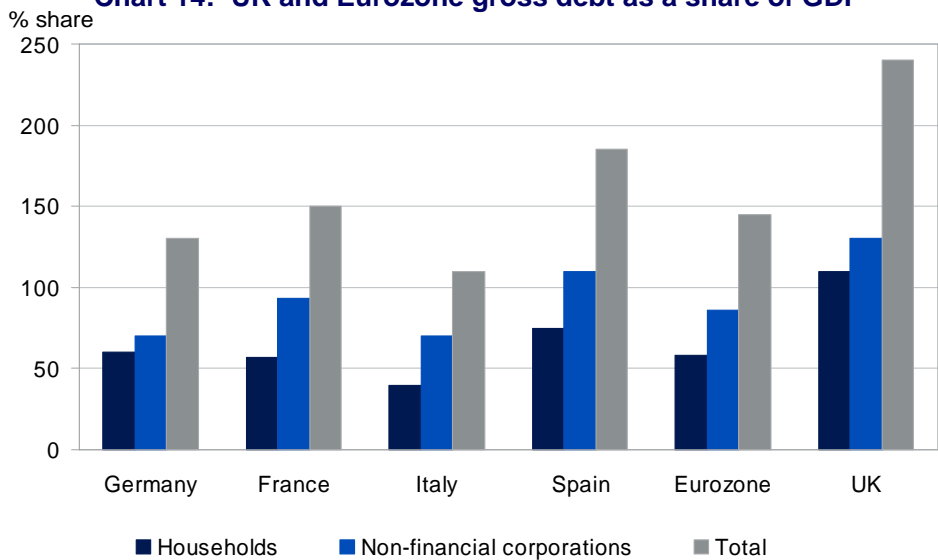
Source: Schroders

In sum, wages could continue to pick up over coming quarters and the likely ECB July hike is probably linked to this fact. But higher wage growth is unlikely to match CPI trends and households are only just beginning to bear the cost of profound changes in the economic environment. The poor outlook for consumer spending will leave little room for higher retail prices and is most likely to keep a lid on underlying inflation trends. We continue to expect that higher wages are most likely to feed into lower margins than into spiralling inflation.

**BoE cuts more than the ECB**

In terms of which of the two central banks (BoE and ECB) is likely to be cutting interest rates more aggressively, we continue to expect the BoE to ultimately reduce policy more than the ECB. And the reasons are simply that in the UK, household debt is at record levels, the highest in the G7 countries, the saving ratio is at record lows, the housing sector is collapsing, monetary policy has not helped consumers or businesses, bank lending is reducing intentions to invest by businesses and the labour market is already loosening. By contrast, while growth across European countries is diverging and there are different factors affecting growth in each country, in terms of debt build up, Europe (on the whole) is in better shape than the UK. Essentially, European economies have not experienced the excesses of the UK in terms of house price overvaluation and a consumer led boom. We continue to expect that interest rates in the UK are reduced to 3.75% by the end of 2009.

**Chart 14: UK and Eurozone gross debt as a share of GDP**



Data to Q4 2007.  
Source: Thomson Datastream, Eurostat

# Forecast Summary

## I. Forecast summary

### Real GDP

y/y%	Wt (%)	2007	2008	Consensus	2009	Consensus
US	31.4	2.2	1.6	1.5	0.9	1.7
UK	5.7	3.0	1.7	1.7	0.8	1.3
Eurozone	25.3	3.0	1.6	1.7	1.3	1.4
Japan	10.4	2.0	1.2	1.3	1.5	1.5
Australia	1.8	4.1	3.2	2.9	2.8	2.8
OECD	74.6	2.5	1.6	1.6	1.1	1.6
China	6.3	11.6	10.8	10.2	8.5	9.4
Emerging*	25.4	7.5	7.0	6.4	5.6	6.2
World	100.0	3.8	3.0	2.8	2.3	2.7

### Inflation CPI

y/y%	Wt (%)	2007	2008	Consensus	2009	Consensus
US	31.4	2.9	3.9	4.0	2.0	2.5
UK	5.7	2.3	3.1	3.1	2.4	2.4
Eurozone	25.3	2.1	2.9	3.3	1.8	2.3
Japan	10.4	0.1	0.7	1.1	0.6	0.8
Australia	1.8	2.3	3.8	4.0	3.0	3.2
OECD	74.6	2.2	3.1	3.3	1.8	1.9
China	6.3	4.6	6.0	7.0	4.5	4.5
Emerging*	25.4	5.2	6.7	7.5	4.9	5.7
World	100.0	2.9	4.0	4.4	2.6	2.4

\* **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 2006 US\$)

### Interest rates

%	Wt (%)	Dec-07	Dec-08	Market	Dec-09	Market
US	31.4	4.25	2.00	3.43	2.00	4.33
UK	5.7	5.50	4.75	6.28	3.75	6.25
Eurozone	25.3	4.00	4.25	5.26	3.75	5.06
Japan	10.4	0.50	0.50	0.97	1.00	1.42
OECD	72.8	3.73	2.78	3.94	2.60	4.32

Market from forward futures strip as at

24/06/08

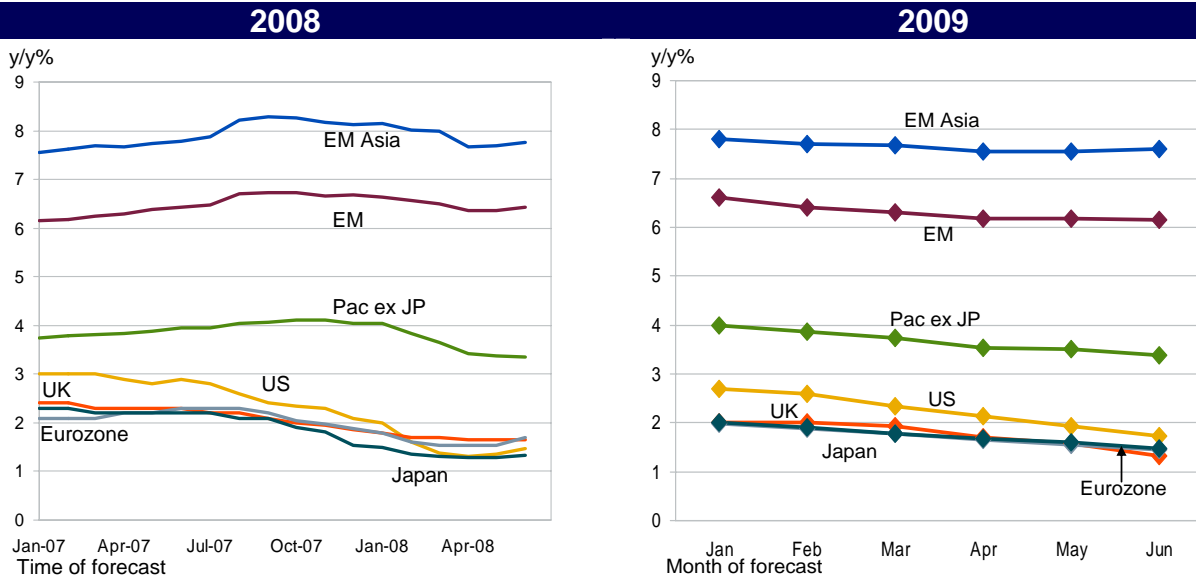
### Key variables

FX	Current	Dec-07	Dec-08	y/y%	Dec-09	y/y%
USD/ GBP	1.97	2.01	1.90	-5.7	1.85	-2.6
USD/ EUR	1.56	1.46	1.55	6.5	1.60	3.2
JPY/ USD	107.8	112.5	105.0	-6.6	100.0	-4.8
GBP/ EUR	0.79	0.72	0.82	13.0	0.86	6.0
Brent crude	135.5	88.8	124.1	39.8	122.0	-1.6
US output gap %GDP	-0.2	0.0	-1.6		-2.4	
Unemploy. %	4.9	4.8	5.5		6.2	

Source: Schroders, Datastream, IMF (historic), Consensus Economics (Jun.)

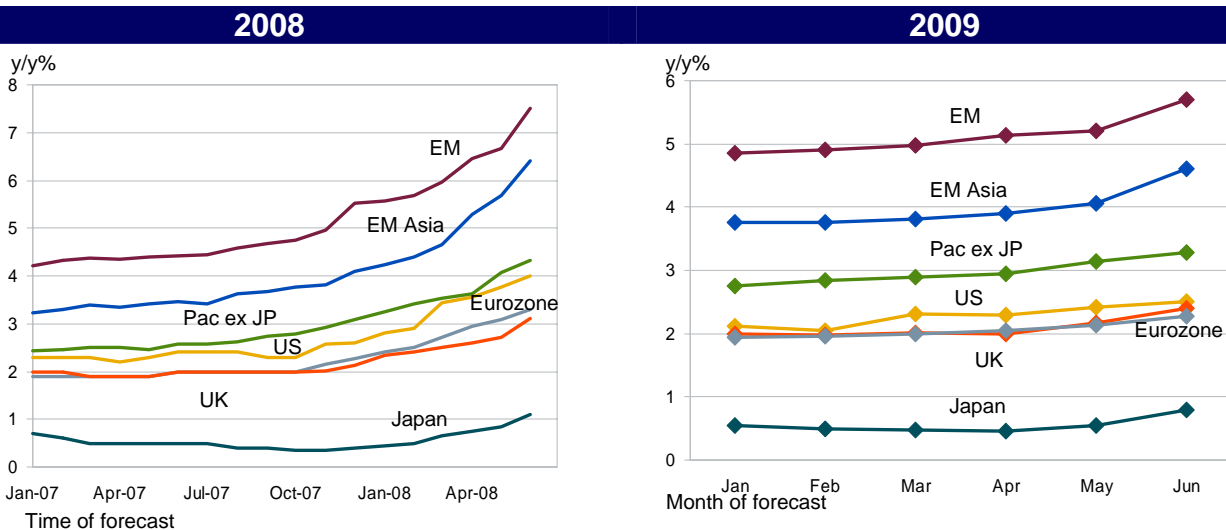
## II. Updated forecast charts

### Chart 1: GDP forecasts



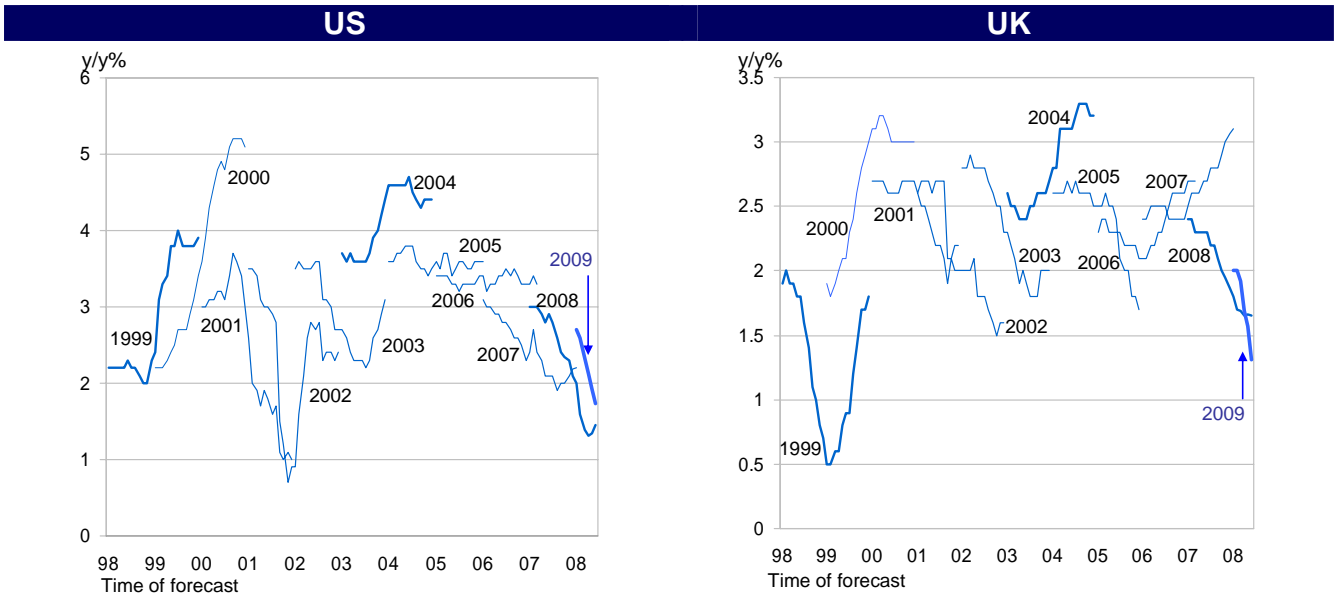
Source: Consensus Economics (Jun.), 2006 GDP weights, Schroders  
 Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore  
 Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand  
 Emerging markets: China, India, Indonesia, Malaysia, Philippines, South 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



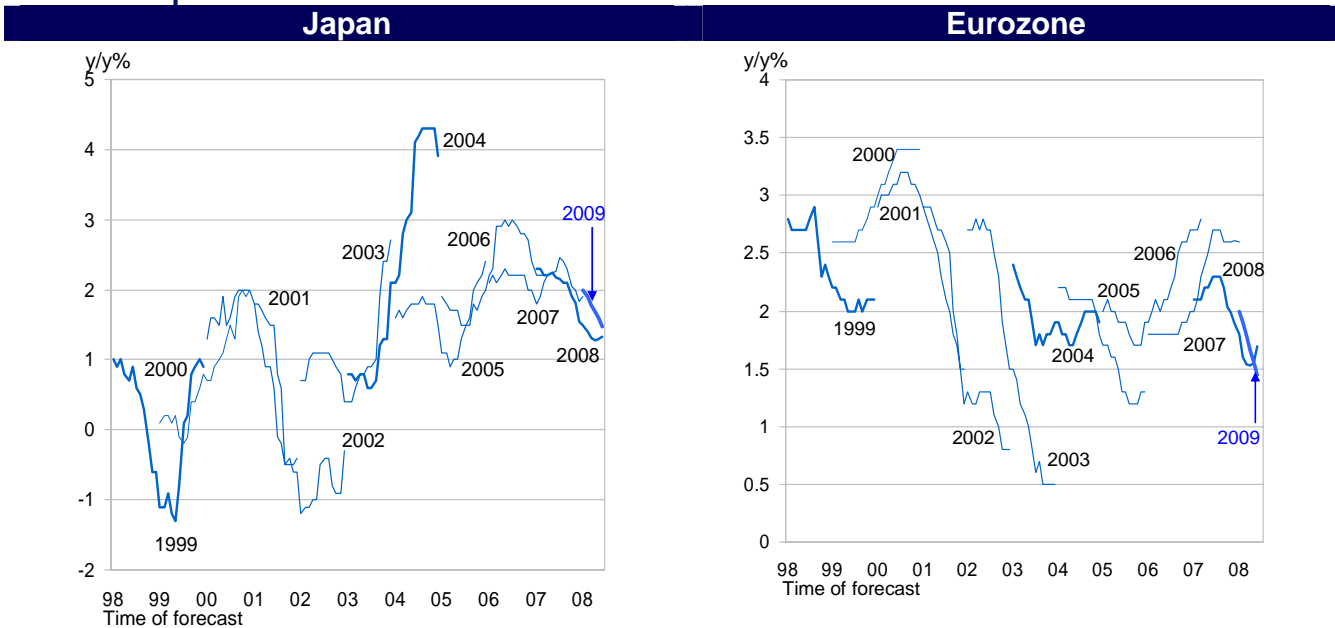
Source: Consensus Economics (Jun.), 2006 GDP weights, Schroders  
 Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore  
 Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand  
 Emerging markets: China, India, Indonesia, Malaysia, Philippines, South 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 3: US and UK GDP forecasts**



Source: Consensus Economics (Jun.), Schroders

**Chart 4: Japan and Eurozone GDP forecasts**



Source: Consensus Economics (Jun.), Schroders

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