

# Schroders

## Economics and Strategy Viewpoint

### Keith Wade

Chief Economist and Strategist  
(44-20)7658 6296

### Robert Sierra

European Economist  
(44-20)7658 2011

### Tina Fong

Analyst, Multi-Asset  
(44-20)7658 3278

### Harish Vekaria

Quantitative Analyst  
(44-20)7658 2722

### Global: Stagflation fears trap markets (page 2)

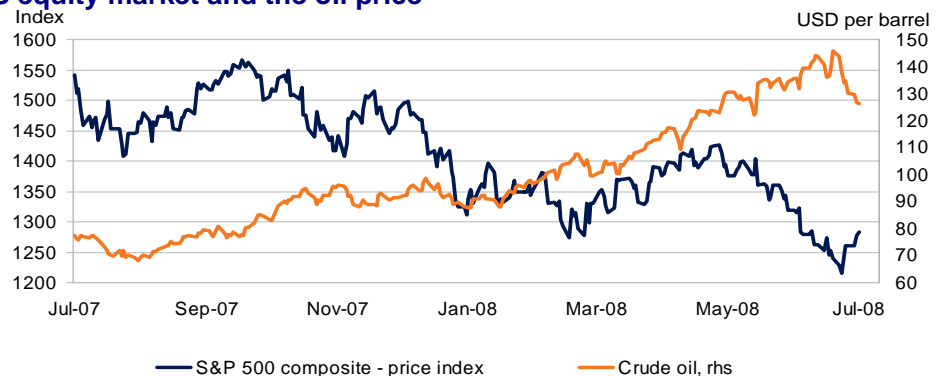
- The combination of rising inflation and slowing growth has paralysed central banks and left equity and bond markets in the worst of all worlds. Our view remains that the credit crunch is tightening policy for the central banks, a view supported by surveys of lending conditions and slower credit growth. As a result, the nascent downturn in housing and consumer spending is likely to be protracted. In turn, the weakness of demand should take care of inflation.
- More immediately, the recent fall in oil prices offers some relief to markets who see this as the key to springing the stagflation trap. Evidence that energy demand is softening indicates we may have reached a turning point in oil prices. In response, risk assets have enjoyed a relief rally from depressed levels. Valuations suggest that this could run further although we will need to see more evidence that headline inflation is peaking before this can be sustained.

### Europe: Risks in the New European economies (page 6)

- Market focus has now returned to growth despite the likelihood that inflation increases in the near term. Data continues to reflect general weakness, both in the UK and in Europe. Markets now expect the BoE to be on hold whilst keeping the possibility that the ECB hikes once more. We expect the BoE to cut before the end of the year and see the ECB on hold in 2008.
- In this issue of the Viewpoint we focus on Eastern Europe, highlighting the challenges faced by the region and provide a brief outlook on these economies. We note that the region is highly interlinked with the Euroarea in terms of trade, financial involvement by Western European banks and the financing of current account deficits through FDI (Foreign Direct Investment) flows and other means. This has implications for the region's outlook for its currencies and for sovereign bonds.
- We find that the region is not homogenous, with some countries more vulnerable than others to factors such as the credit crunch or a slowdown in the Euroarea. From the viewpoint of the Euroarea, countries such as Germany, Italy and Austria could be affected by difficulties in Eastern Europe.

### Forecast summary (page 17)

#### US equity market and the oil price



Source: Thomson Datastream



# Global

## Markets trapped by stagflation

### *Bank minutes reflect policy dilemma*

Rising inflation has left policy makers paralysed in the face of a weakening global economy. The latest minutes from the Bank of England monetary policy committee (MPC) highlight the dilemma with one member voting for a rate cut, another for a rate rise and seven for no change. From a market perspective, it is the worst of all worlds as neither equity nor bond markets can see any prospect of monetary relief.

With all due respect to MPC hawk Tim Besley, an increase in interest rates is the last thing the UK economy needs today. Calls for higher rates in the US are similarly misplaced. However, such a view does not mean that we are resigned to a spell of higher inflation. Quite the opposite. Instead, we would argue that monetary policy is currently tight and is set to deliver lower inflation. If anything in our view, policy rates could be cut in an attempt to loosen policy.

### *We see little case for higher rates in the US or UK*

Underlying this is the belief that the credit crunch will take care of the inflation problem. We need to go beyond the level of short rates to the behaviour of borrowers and lenders to recognise that monetary policy is not supportive of activity at present. The weakness of mortgage lending, surveys showing that banks are tightening their lending conditions and the slowdown in credit growth generally point to an environment in which the cost of capital is high rather than low.

One striking way of looking at this is the comparison between the mortgage rate and house price inflation. The gap between the two can be seen as a crude measure of the incentive to borrow i.e. when house price inflation exceeds the mortgage rate borrowers are drawn in as their expected return exceeds the cost of funding and vice versa. Today we are looking at a situation where the mortgage rate is well in excess of house price inflation in both the US and UK (see chart 1) an indication that borrowing and the housing market are likely to remain weak.

**Chart 1: "Real" interest rates in the housing market**  
**US** **UK**



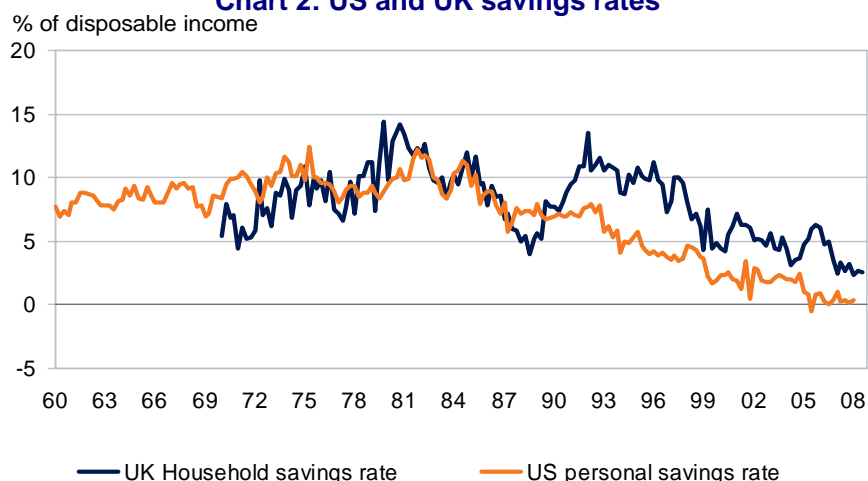
Source: Thomson Datastream, Schroders  
 Note: Mortgage rate minus house price inflation

### **Long booms and long busts in housing**

Note that this implies that people form their expectations about house prices in a backward looking way – taking the current price movement as the best guess of the future. Such auto regressive behaviour suggests that individuals are not forward looking and have difficulty recognising value when it finally emerges. While not a great endorsement for the rational consumer such behaviour does fit the pattern of long booms and busts in housing markets. In the UK, empirical work finds that momentum terms are significant in explaining house prices, indicating that it will be years rather than months before the market turns around.

The key for policy makers will be the extent to which this affects consumer spending. The fall in housing turnover will result in weaker consumer spending on durables and of course will hit employment in those sectors closest to the fray. Furthermore, although the match between savings rates and house prices is by no means precise, the negative wealth effect from falling house prices will work to push the savings rate higher. This will act as a longer term drag on consumer spending – an effect compounded in the UK and the US where the savings rate is low by historical standards following the house price boom.

**Chart 2: US and UK savings rates**



Source: Thomson Datastream

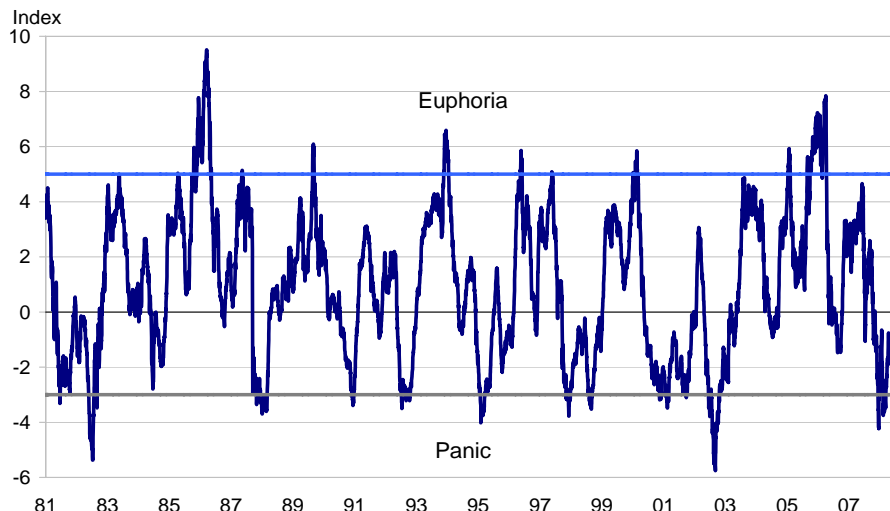
### **Recent fall in oil price offers some relief**

For the time being, the market is focussed on the price of oil. The most immediate way out of the stagflation trap is a fall in oil prices, reducing headline inflation and freeing central banks to ease policy. At the time of writing, the oil price is obliging as evidence mounts that demand is finally responding to the increased cost of energy. Inventory is beginning to build as consumers cut back on driving or switch to more fuel-efficient vehicles – an outcome which has left the US automakers floundering as their strategy of building products for a world of cheap energy hits the rocks. In the meantime, the reduction in energy subsidies in the emerging markets is beginning to have an impact with growth forecasts being trimmed.

Although lower oil prices are in theory good news for both equities and government bonds, in practice it is the former which have responded positively. Equities have rallied (see chart on front page) while bond yields have ticked up.

It would seem that lower oil prices are improving risk appetite, prompting a switch from the safety of government bonds to riskier equities and credit. The extreme level of the Credit Suisse risk appetite index indicates that the market is set for such a move (chart 3).

**Chart 3: Credit Suisse Risk Appetite Index**

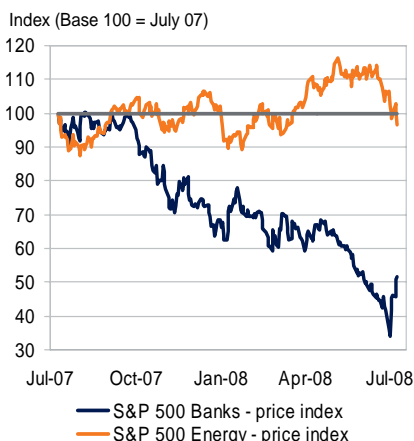


Source: Credit Suisse

***An end to the energy-financials trade?***

The decline in oil prices also threatens to bring an end to one of the most profitable trades within the equity market. The long energy-short banks trade has been exponential over the past 12 to 18 months (see chart for the US experience) as the fortunes of both sectors have diverged to an alarming degree. While both sectors are important to the equity market, an environment where this trade reverses is more likely to be positive for equities and risk assets overall. Lower energy prices and a more positive backdrop for banks must be more supportive of the economy and the market than the reverse.

**Charts 4 & 5: Performance of US banks and energy sectors Past year**

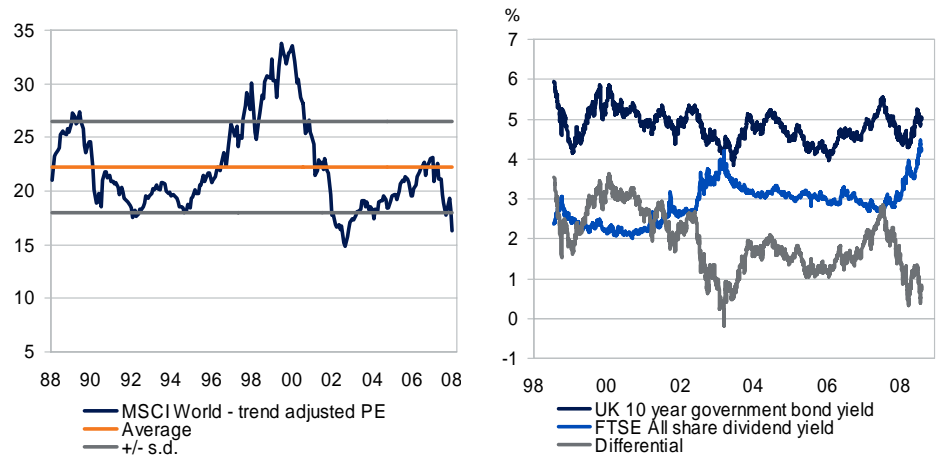


Source: Thomson Datastream, Schroders

**Valuations attractive, but inflation fears need to subside for markets to be free from stagflation trap**

Most of the historical evidence on bear markets suggests it is early days, but a number of factors indicate that this should not be a prolonged period of weakness. In particular, valuations are attractive with earnings and dividend yields at levels which compare favourably to their history or to bonds. Of course, valuations reflect current earnings which will fall, an inevitability which analysts seem unable to accept. However, the point is that much is in the price (see charts 6 & 7).

**Charts 6 & 7: Trend adjusted PE and UK dividend yield versus bond yield**



Source: Thomson Datastream, Schroders

Looking further ahead, an improvement in inflation would help lift risk assets. As lower inflation frees central banks to ease policy. The bigger challenge would then be growth. If, as we suspect, the housing and consumer sectors are in for a prolonged period of retrenchment then many companies will struggle to grow earnings. The worries that interest rate cuts alone can revive the economy will resurface and the debate about whether the liquidity trap, rather than stagflation trap, will return.

# Europe

## Wages still key to monetary policy

### ***Market's attention shifts back to growth***

The past month has been rather turbulent to say the least with markets fully reversing the 75bp of interest rate hikes that were priced in the BoE by the end of the year. Markets now expect rates to remain on hold at 5% by year-end. The reversal is not surprising after a flood of poor data, be it on the housing market, credit conditions or slowing PMIs – even as inflation continues to rise to new highs. Similarly, markets have reduced the chances of another hike at the ECB following recent softer data, (even in Germany) that points to a sharp correction to the strong first quarter. Recent comments by the German Finance Minister suggested that Q2 GDP could be somewhere in the -0.75% to -1.5% region. Markets however retain a 30% probability that the Bank hikes again before the end of the year. Our base case scenario remains for the ECB to be on hold with rate cuts next year, however, we argued in the previous Viewpoint that the labour market presents problems for the ECB and this increases the risk that the ECB responds to further signs of higher wage costs.

### ***ECB keeping an eye on wages***

We highlighted in last month's report that the Euroarea labour market is fairly tight, with rising total wage costs not contained by productivity, which has fallen in recent quarters. In essence, for Euroarea wages to stop rising we would need to see employers shedding labour more rapidly (which we are beginning to see, albeit mostly in the construction sector so far) or for wage indexation to be curtailed. (More details in June's Viewpoint)

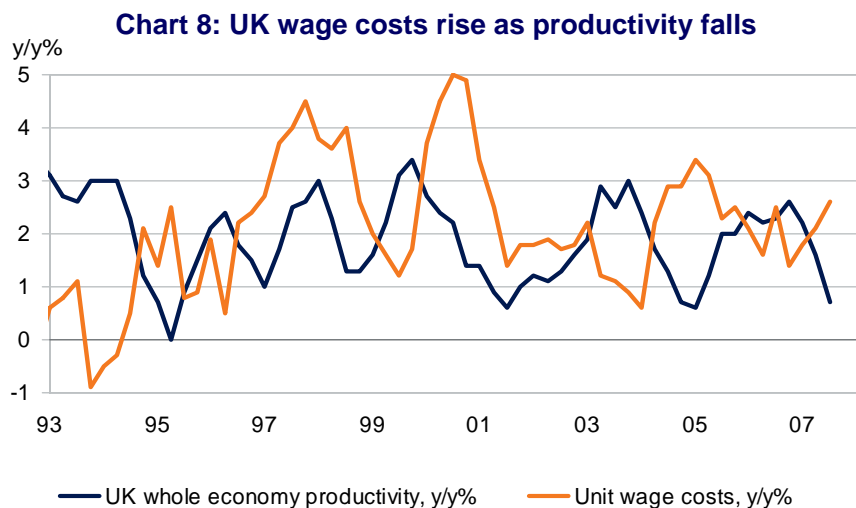
### ***UK labour market turns, wages fall***

In the UK, the slowdown is more advanced. House prices are falling rapidly and the tightening in loan standards adds to the likelihood of a long housing slide. The drag from the credit crunch, weak real incomes and falling property prices is spreading into consumer spending, construction and business investment. Recent labour market data shows that unemployment has already risen, by 45,000 in the last four months, with vacancies falling and the number of benefit claimants rising. As a consequence, average earnings in the 3 months to May have declined to 3.8% from 3.9% with the monthly reading for June alone falling to 3.4% from 3.9% at the beginning of the year.

At the same time, inflation continues to head upwards, with input prices rising at an annual rate of 30% and output prices increasing by 10%, highlighting the squeeze faced by producers. The latest CPI reading for June at 3.8% was larger than we expected and therefore the peak in inflation is now likely to be closer to 4.9% than the 4.5% we previously forecast. With average earnings falling and inflation rising, real wages are now negative, a situation last experienced in the early 1990s.

However, while average earnings eased the broader measure of labour costs (unit wage costs) picked up as productivity growth continues to decline. (see chart below). The slowdown in employment growth should enhance productivity, but at the same time the rate of economic growth is decelerating rapidly. In essence, it will be a race between these two offsetting components that determines how far labour costs will rise. However, we would argue that in contrast to the Eurozone, the UK labour market is more flexible than that of the continent. Ultimately, unit wage costs

**BoE cutting rates ahead** are likely to remain in a tolerable range, with higher costs likely to result in lower profit margins and not inflation. With inflation peaking in Q308, (a prospect helped by falling oil) we continue to expect the BoE to eventually reduce interest rates.



Source: Thomson Datastream

### Risks in the New European economies: summary

The piece that follows aims to shed some light on the risks faced by Eastern Europe. We provide an economic update of the region and relate this to the three channels through which we suspect Eastern Europe growth could be affected, namely trade flows, financial exposure by western European banks and flows of FDI to the region. It is worth noting that Eastern Europe as an entity is rather diverse and any impact on the region will depend on the strength of the links just mentioned.

In terms of trade, we find that the leading Central European countries (Czech Republic, Hungary and Slovakia) are at risk particularly if Germany slows down. As well as the direct impact on exports from a slowdown in the Euroarea we also highlight the adverse effect of appreciating currencies on trade whilst showing how currencies are helping to contain inflation. We find that taken as a bloc, eastern Europe is the Euroarea's major trading partner, even if individually their shares are small. Eastern Europe as an export destination is almost as large as the US and the UK put together.

Further, a financial crisis in central Europe, in response to a reduction in lending to the region would expose some countries to the difficulty of financing their current accounts. The impact on Eastern Europe would be larger than the trade effect given the strong exposure of western banks in the region. A number of Eastern European economies have strong exposure to Austrian Banks (particularly the CEE4 countries with the exception of Poland) with Baltic countries greatly exposed to Swedish Banks. However, from the point of view of Swedish banks, Eastern Europe, represents just over 10% of their total foreign claims.

Lastly, with regards to FDI, the main beneficiaries have been the CEE4, with Germany accounting for a large share of the flows, mainly heading to the automobile industry and business and telecommunications sector. Recent data shows that FDI have been falling exposing those countries which are relying on non-FDI flows, namely Hungary and the Baltic countries.

The various economic challenges faced by the countries in the region, be they strong or weak trade links, high inflation, external imbalances - and the way these are financed - are reflected in different market pricing, with investors "discriminating" against those countries they see as being at risk resulting, for instance, in high sovereign default risk premia or increased volatility in the currency markets.

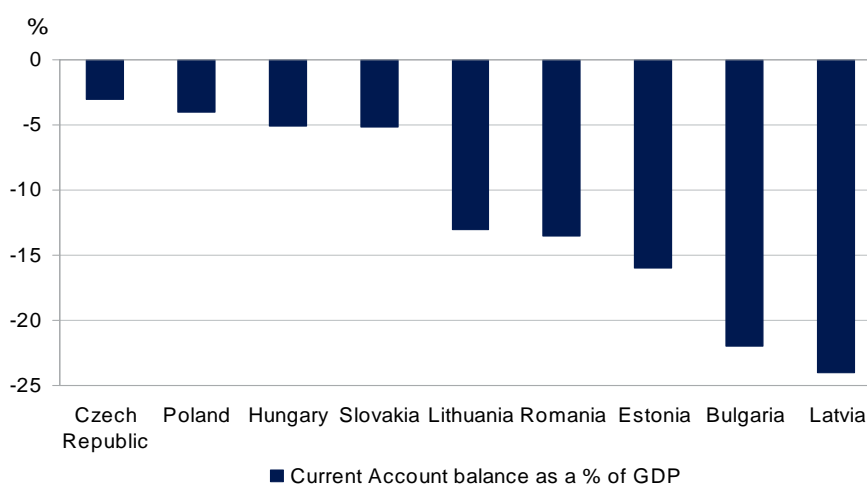
### Risks in the New European economies

#### *Two broad groups within Eastern Europe*

When thinking of the risks facing Eastern European countries it would be wrong to think of them as one homogenous group given the different risks and outlooks faced by each of these countries. Broadly speaking, there are two groups within the emerging European countries, namely the CEE4, composed of Poland, the Czech Republic, Hungary and Slovakia, where growth is largely balanced and current accounts are not facing significant imbalances. The other group, composed of the Baltic (Estonia, Latvia and Lithuania) and Balkans countries (Bulgaria and Romania), on the other hand has experienced imbalanced growth and very large current account deficits.

While current account deficits in the larger eastern European countries (the CEE4 except Hungary) are largely financed by FDI, other countries such as Hungary and the Baltic and Balkan countries are increasingly being financed by loans from banks or from foreign companies or through portfolio investments and therefore have experienced rapid increases in their external debt, particularly in Hungary, the Baltic and Balkan countries.

**Chart 9: Growing imbalances across Central and Eastern Europe, 2007**



Source: Eurostat

**Current account imbalances widening**

The growing divergence among eastern European economies in terms of external imbalances, rising indebtedness as well as inflationary pressures has lead investors to discriminate against those countries which are viewed as risky. The financial crisis of the last summer affected the countries with the largest macroeconomic imbalances more severely (Hungary, the Baltic and Balkan countries). In these countries, the currencies as well as the stock and bond markets have been under pressure since July of last year as have the CEE4, but to a limited extent.

The currencies that are in a floating exchange-rate regime have as a whole recorded a period of increased volatility. This is in particular the case for the Romanian Leu and the Hungarian forint, which are increasingly funding their current accounts with non-FDI flows, and to a lesser extent the Polish, Czech and Slovakian currencies.

Until March of this year, the financial crisis had weakened the Romanian and Hungarian currencies (chart below) to a larger extent than the currencies of Poland, the Czech Republic and Slovakia, which have appreciated rather sharply. The reasons for this divergence in currencies performance are linked to the deterioration of macroeconomic imbalances in Romania and Hungary, but also because of the relatively good performance posted by the Polish, Czech and Slovak economies.

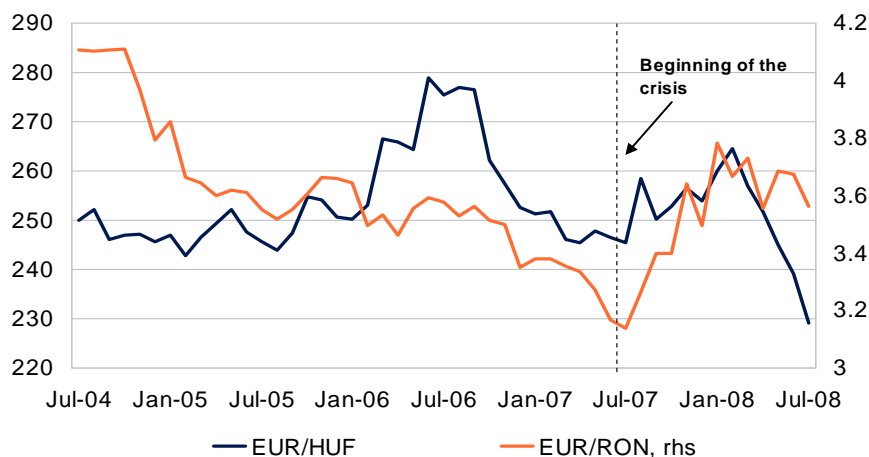
The CEE4, with the exception of Hungary have in general seen better growth, met Euroarea public finances criteria, have experienced limited inflationary pressures, the prospect of euro adoption in 2012-2014 reinforces investor confidence and have lower current account deficits.

**Table 1: Exchange rate regimes in Eastern Europe**

<b>Poland</b>	Float
<b>Hungary</b>	Float
<b>Czech Republic</b>	Managed float
<b>Slovakia</b>	Fixed exchange rate versus the euro
<b>Baltic countries</b>	Currency board with the euro within the ERM framework
<b>Balkan countries</b>	Currency board with the euro

Source: Schroders

**Chart 10: Exchange rates against the Euro – Hungarian Forint and Romanian Leu**



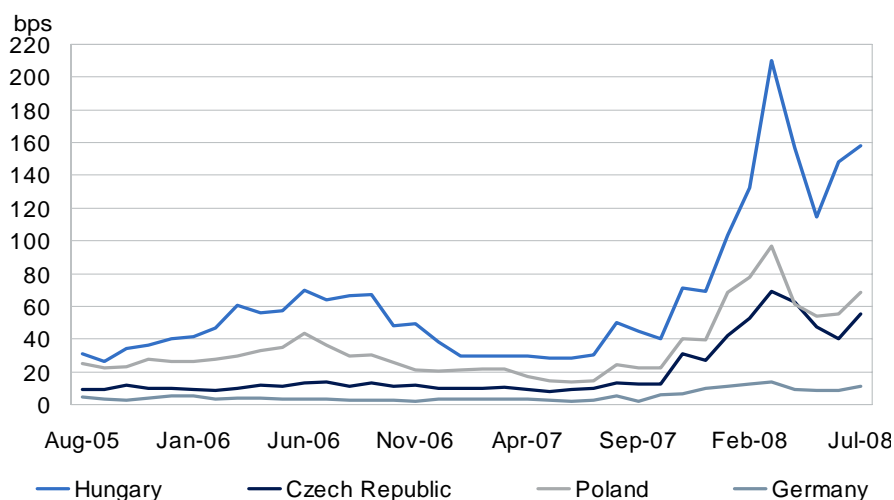
Source: Thomson Datastream



### ***Sovereign bonds also reflect fundamentals***

Further, sovereign risk in the eastern European countries, as measured by 10 year CDS (corporate default swaps), has also largely evolved in a volatile way since July 2007. Investors' bias against risky countries has resulted in high sovereign default risk premium. For central European countries the sovereign risk premium remains relatively low (40-70 bps) with the exception of Hungary (160 bps) while the Baltic and Balkan countries post far higher risk premia (170-250 bps), which demonstrate a certain investor mistrust towards these economies.

**Chart 11: Sovereign 10-year CDS for selected Eastern European countries**



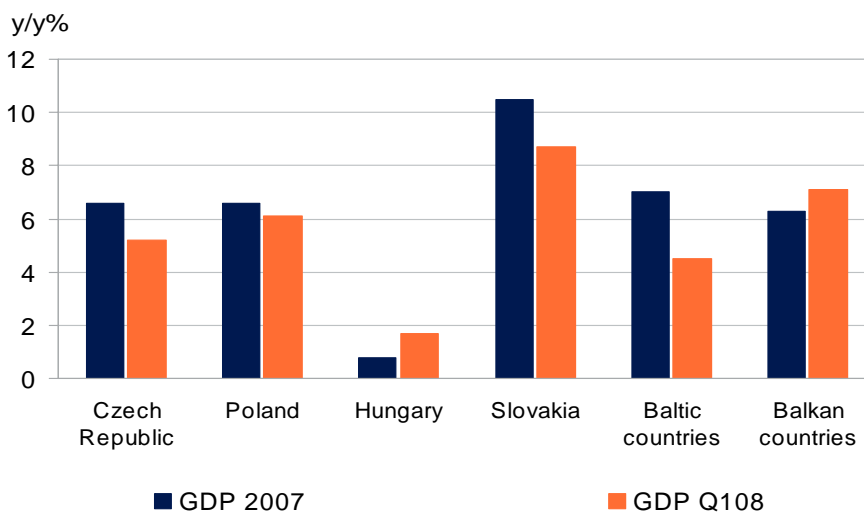
Source: Thomson Datastream

### ***Inflation rises, wages key but currencies help***

The growth and inflation outlook for the region is also mixed. In common with other regions of the world, inflation has also increased in eastern Europe, with annual CPI above target rates and likely to rise further in the near term on the back of gas and heating price increases before it pulls back next year. The potential risk of an acceleration in nominal wage growth is evident in the CEE4 (with the exception of Hungary) where higher wage costs could be passed on given strong domestic demand and rapidly tightening labour markets. In Hungary, in contrast, growth (and domestic demand specifically) is rather sluggish but has failed, so far, to slow down wage growth and inflation. As a result, monetary policy has been tightened considerably, by 100bp alone since March to 8.5%, even as growth slows and this has helped to strengthen the currency, which in turn should help to contain inflation. Appreciating currencies and vigilant central banks in other CEE4 should help to combat inflation.

The problem for Hungary is that its starting position is weak, exports remain the sole engine of growth and rate cuts are needed to stimulate domestic demand. Other eastern European countries have a better balance of growth with strong domestic demand likely to be only partly offset by a slowdown in exports both because of trade exposure to the Euroarea and appreciating currencies.

**Chart 12: Eastern European slowdown modest so far, sharp fall in Baltic countries**



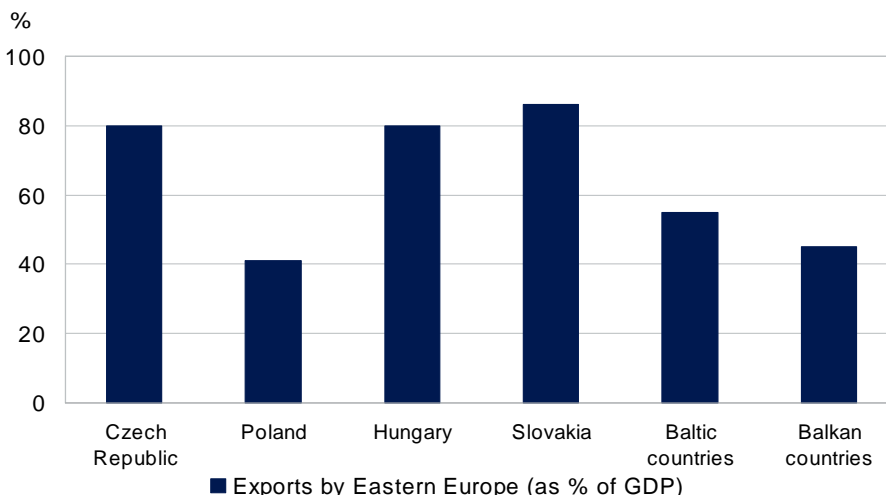
Source: Eurostat

Note: GDP Q1 08 is the change in real GDP from Q1 2007 to Q1 2008.

**Eastern Europe has high trade links with Euroarea**

Indeed, a potential risk to Eastern European countries is that a slowdown in Eurozone growth is likely to lead to a substantial drop in trade activity. From the viewpoint of eastern European countries, the Eurozone is an important trading partner receiving between 50%-60% of total exports (as a percentage share of all Eastern European exports). Imports from the Eurozone fall between 40%-60% of total import turnover. We see that the Czech Republic along with Hungary and Slovakia are greatly exposed to changes in the Eurozone's economic cycle while the other countries have either lower openness (measured as export share of GDP) or less exposure to EU countries.

**Chart 13: Exports by Eastern Europe to Euroarea (as a % of GDP), 2007**



Source: Eurostat

Looking at individual Euroarea countries, it is revealing to see that trade with the Central and Eastern European countries rose particularly strongly for Germany. The table below highlights the trade links between eastern European and the Euroarea, in terms of export and import flows as a percentage of total trade flows.

The strong concentration of eastern European foreign trade with the Euroarea raises the question of whether some transition countries are already too heavily oriented towards the Euroarea. Given the high reliance on trade with the Euroarea and with Germany in particular – the new emerging European countries are particularly exposed to a downturn in Eurozone growth.

**Table 2: Trade market shares - % of total exports and imports by destination, 2007**

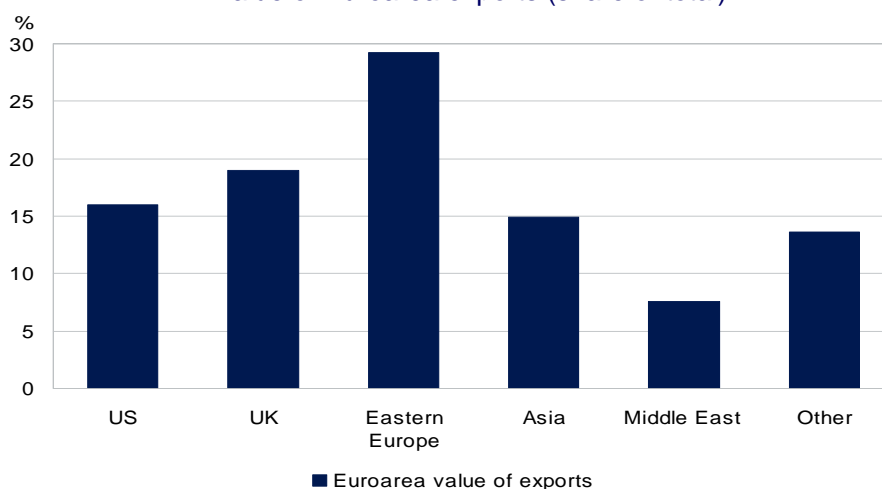
	Total to Euroarea	Germany	France	Italy	US	UK	Russia
<b>New EU states</b>	55.4	28.1	5.2	6.4	3.0	4.1	5.5
<b>Hungary</b>	59.5	29.5	4.6	5.9	4.1	3.6	3.8
<b>Czech Republic</b>	58.9	34.9	4.8	4.9	2.8	4.1	2.9
<b>Poland</b>	57.6	30.5	6.0	7.0	1.9	4.3	5.3
<b>Slovakia</b>	60.3	30.3	3.0	5.6	2.6	1.9	6.4
<b>Romania</b>	59.0	16.2	7.4	21.6	3.0	5.0	3.7
<b>Estonia</b>	40.4	9.9	2.2	1.9	2.5	4.7	11.4

Source: Eurostat

### How important is Eastern Europe to Western Europe?

From a Euroarea perspective, the main trading partners for EU countries remain the UK and the US, with exports accounting for 19% and 16% respectively. Individually, eastern European countries account for relatively small shares but when combined (here we add Russia) the region becomes the Euroarea's largest trading partner, comprising close to 30% of its exports (Russia responsible for a third of the Eastern Europe total). In terms of country exposure, we find that Germany and Italy are the most exposed.

**Chart 14: Eastern Europe's trading partners, 2007**  
Value of Euroarea exports (share of total)



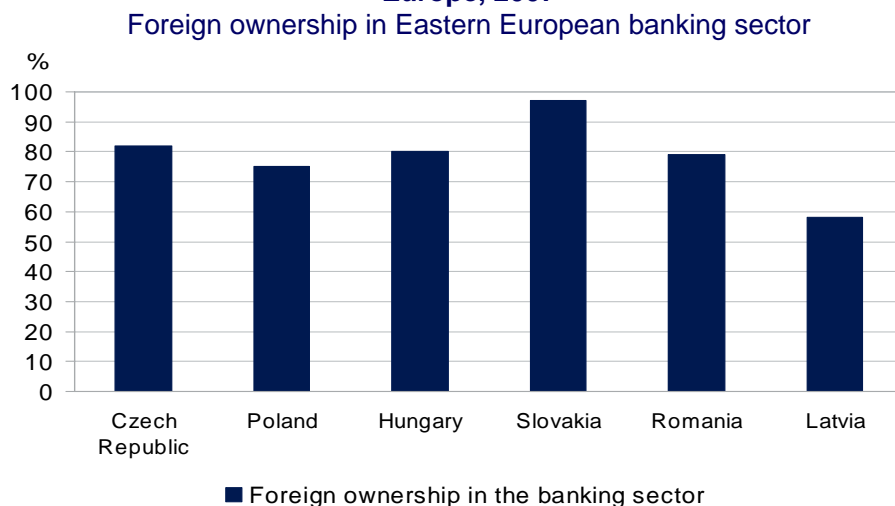
Source: Eurostat

### ***Growing presence by western European banks in the region***

### **Growing financial exposure by Euroarea banks to Eastern Europe**

The increase in trade links between Eastern and Western Europe is also mirrored in growing financial links and the growth of the private sector. Indeed, the rapid expansion in private sector growth in the new European members has been closely linked to the entry of foreign banks, mostly western European.

**Chart 15: Western European banks have a large stake in Eastern Europe, 2007**



Source: BIS

### ***Credit crunch could trim lending to Eastern Europe***

In a way, the risk to eastern European countries is potentially greater than the slowdown in trade since financial contagion could be transmitted from one country to another via a Euroarea owned bank e.g. if a problem in Slovakia forces Austrian Banks (who have a strong exposure in that country) to cut back lending in other countries where it has a large involvement. The ongoing credit crunch could lead Euroarea banks to tighten lending criteria directly on Eastern European countries. The table below shows the extent of Euroarea involvement in eastern Europe banking sector.

**Table 3: Eastern European exposure to Euroarea banks (as % of total exposure, 2007)**

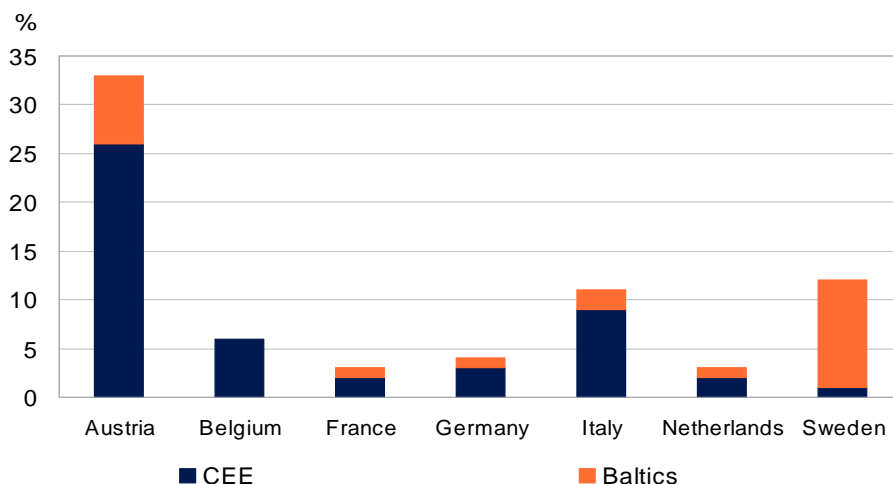
	Poland	Czech Republic	Hungary	Slovakia	Baltic average
<b>Austria</b>	5	30	25	35	1
<b>Germany</b>	18	6	25	5	10
<b>France</b>	7	20	6	6	0
<b>Belgium</b>	8	24	10	15	0
<b>Italy</b>	20	8	19	23	1
<b>Netherlands</b>	11	3	5	7	0
<b>Sweden</b>	2	0	0	0	70
<b>Other</b>	29	9	10	9	18

Source: BIS

While these shares are large, from the perspective of the western European banks, exposure to eastern European countries represents fairly small shares of their total foreign claims (see chart below), with the exception of Austrian banks who have a large (30%) share of their total foreign claims concentrated in Eastern Europe.

**Chart 16: Exposure by Western banks varies across Euroarea banks, but generally low**

Western banks exposure to Eastern Europe (% of total foreign claims, 2007)



Source: BIS

A third link between Eastern Europe and the Euroarea is the growing flow of FDI into the formerly planned economies.

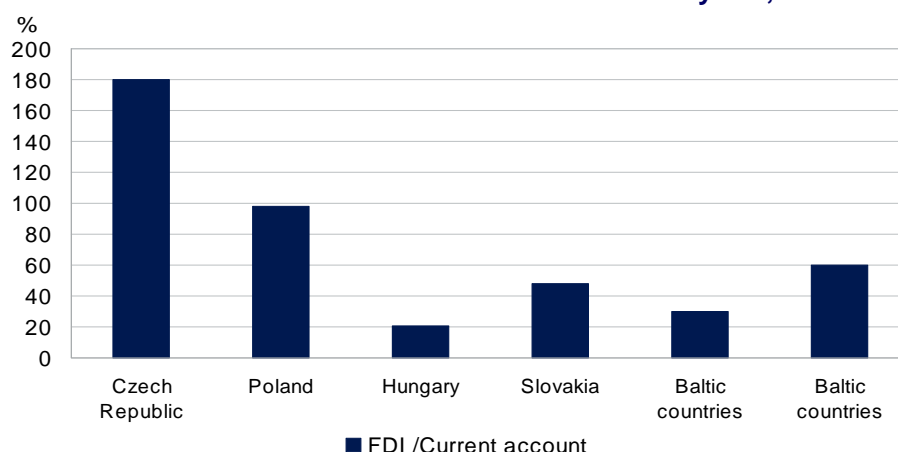
***FDI to the region grows in importance***

In 2006, the latest date for which we have data, the Euro 15 countries invested €23.2bn in Eastern Europe, up from €19.1bn in 2004 but down from 2005. The stock of FDI held in the new states reached €273bn at the end of 2006, and the breakdown of the numbers show that Poland, Hungary and the Czech Republic were the main partners, with 68% of all EU 15 stocks held in these countries. There has been a noticeable decline in FDI over the past year.

The main investor in the new member states, unsurprisingly given its proximity, was Germany accounting for 27% of total FDI for the period 2004-2006, with the main recipients being Poland and Hungary. Spain, was the second largest investor (to Hungary) followed in third place by Austria with the bulk of its investment going to Romania.

The majority of FDI went to the service sector, predominantly to Business and financial sectors as well as telecommunications. Manufacturing also benefited greatly with a quarter of EU 15 FDI stocks going to Vehicle and Transport equipment industries highlighting the importance of the automobile industry to the new Central European member states.

**Chart 17: Current account balance covered by FDI, 2007**

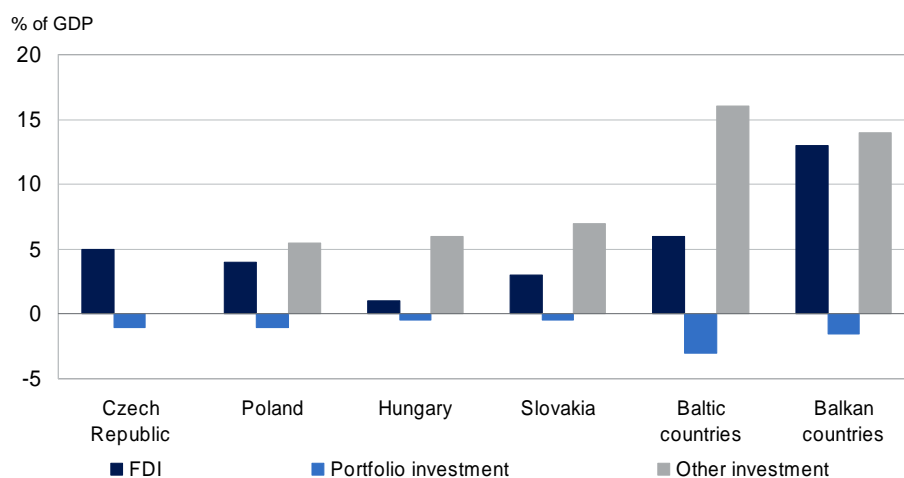


Source: Eurostat

**Some countries fund current account via non-FDI sources**

We would also highlight the importance of FDI flows (chart below) and other sources of financing the current account in eastern Europe, noting how Hungary and the Baltic countries rely less on FDI flows to finance their current account deficits, relying instead on loans from banks or from foreign companies.

**Chart 18: Emerging Europe – financing structure of current accounts, 2005**



Source: Eurostat

Summarising, we have identified a number of key risks facing the new emerging countries of eastern Europe. It is fair to say that the region is not homogenous in terms of the strength of the links to western Europe, be they through closer trade, rising credit growth financed by a growing presence of western banks or the rising flows of FDI over recent years. Overall, we would conclude that the CEE4 countries, with the exception of Hungary, are in a better position to cope with a slowdown, given their strong initial growth positions and that the economy has been driven mainly by domestic demand; that is the case of the Czech Republic, Slovakia and Poland where overall risks are relatively low, with the latter probably the least vulnerable in the region. High-risk countries remain the Baltic and Balkan countries as well as Hungary, given their close trade links and large financial exposure to

Euroarea banks - risks are summarised in the table below. We noted that exports for some countries in eastern Europe are still the main driver of growth for some countries and recent appreciation of currencies as well the slowdown in the Euroarea will likely lead to a slowdown in trade. And in that respect, a slowdown in Germany poses problems for a number of eastern European countries given the large share of exports going to that country.

In terms of inflation risks, again, the picture across the region is varied but on the whole where domestic demand has been strongest (CEE4) and labour markets are tight, inflation has risen significantly though currency appreciation has helped to offset to some extent the boost from commodity led inflation. As a consequence, interest rates have been tightened across the region and in turn have driven currencies higher. We have also highlighted that those countries which finance their current account deficits through non-FDI flows are likely to fare worse as the credit crunch lingers on and in that respect it is countries such as the Baltic, Balkan and Hungary that are likely to be at risk given their large exposure to western banks.

Overall, how the different hurdles are managed and the extent of the slowdown in the Euroarea will be deciding factors for the outlook of the region and investors will continue to discriminate against those countries which have weak fundamentals.

**Table 4: Risks to Eastern European countries from a slowdown in the Euroarea given strong links in:**

	Czech Republic	Hungary	Poland	Slovakia	Estonia	Latvia	Lithuania	Bulgaria	Romania
Trade	High	High	Low	High	Medium	Low	Medium	Medium	Low
External imbalance	Low	Low	Low	Low	High	High	High	High	High
Financial exposure	Medium	High	Low	Medium	High	High	High	Medium	High
Total risk	Medium	High	Low	Medium	High	High	High	Medium	High

Source: Schroders

# 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	1.5
UK	5.7	3.0	1.7	1.5	0.8	1.0
Eurozone	25.3	3.0	1.6	1.6	1.3	1.2
Japan	10.4	2.0	1.2	1.4	1.5	1.3
Australia	1.8	4.1	3.2	2.9	2.8	2.8
OECD	74.6	2.5	1.6	1.6	1.1	1.4
China	6.3	11.6	10.8	10.0	8.5	9.3
Emerging*	25.4	7.5	7.0	6.4	5.6	6.1
World	100.0	3.8	3.0	2.8	2.3	2.6

### Inflation CPI

y/y%	Wt (%)	2007	2008	Consensus	2009	Consensus
US	31.4	2.9	3.9	4.3	2.0	2.8
UK	5.7	2.3	3.1	3.4	2.4	2.8
Eurozone	25.3	2.1	2.9	3.6	1.8	2.4
Japan	10.4	0.1	0.7	1.4	0.6	1.0
Australia	1.8	2.3	3.8	4.2	3.0	3.2
OECD	74.6	2.2	3.1	3.6	1.8	1.9
China	6.3	4.6	6.0	7.0	4.5	4.8
Emerging*	25.4	5.2	6.7	7.8	4.9	6.0
World	100.0	2.9	4.0	4.6	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	3.08	2.00	4.01
UK	5.7	5.50	4.75	5.82	3.75	5.65
Eurozone	25.3	4.00	4.25	5.13	3.75	4.90
Japan	10.4	0.50	0.50	0.91	1.00	1.20
OECD	72.8	3.73	2.78	3.69	2.60	4.05

Market from forward futures strip as at

24/07/08

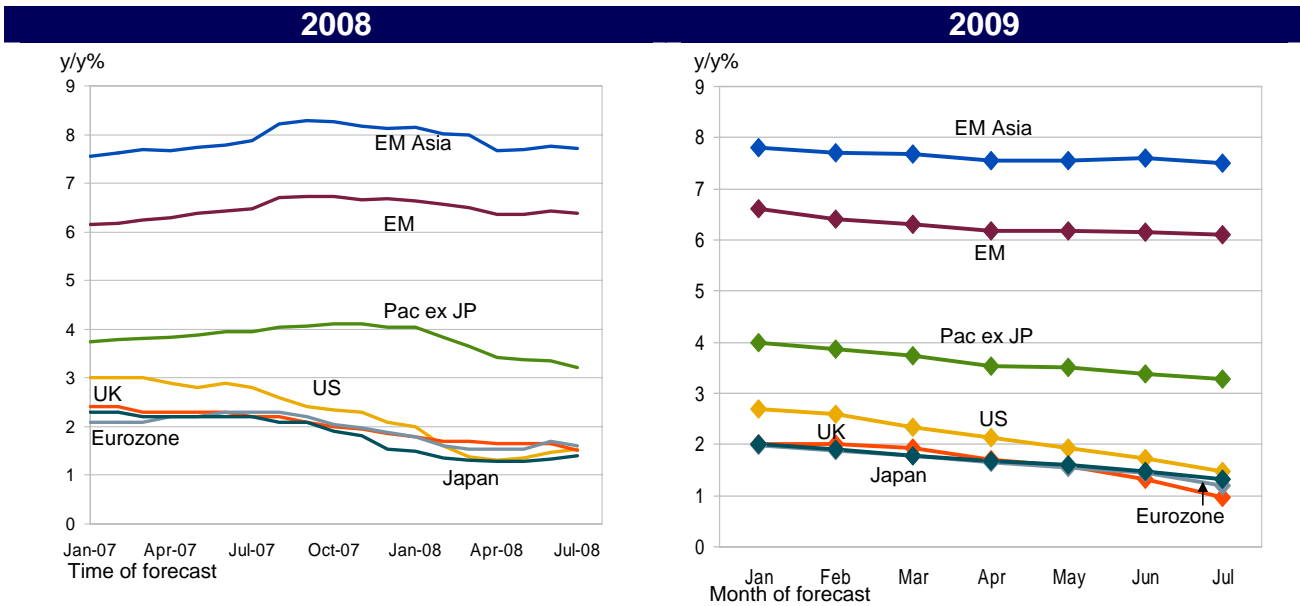
### Key variables

FX	Current	Dec-07	Dec-08	y/y%	Dec-09	y/y%
USD/ GBP	1.99	2.01	1.90	-5.7	1.85	-2.6
USD/ EUR	1.57	1.46	1.55	6.5	1.60	3.2
JPY/ USD	107.4	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	125.0	88.8	124.1	39.8	122.0	-1.6
US output gap %GDP	-0.9	0.0	-1.8		-2.5	
Unemploy. %	5.3	4.8	5.7		6.4	

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

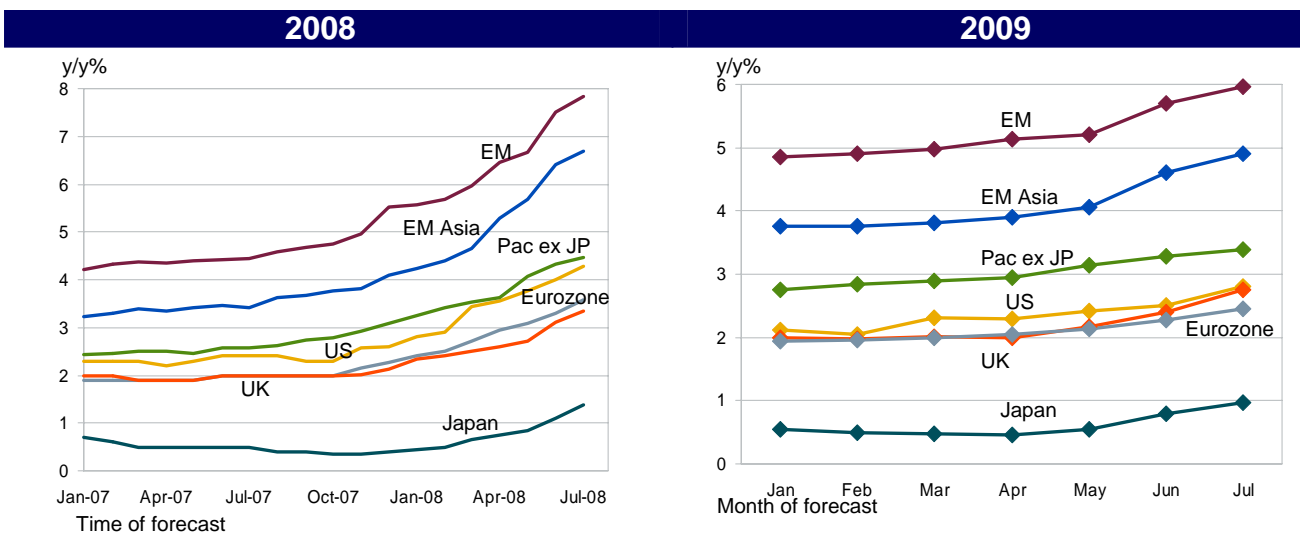
## II. Updated forecast charts

### Chart 1: GDP forecasts



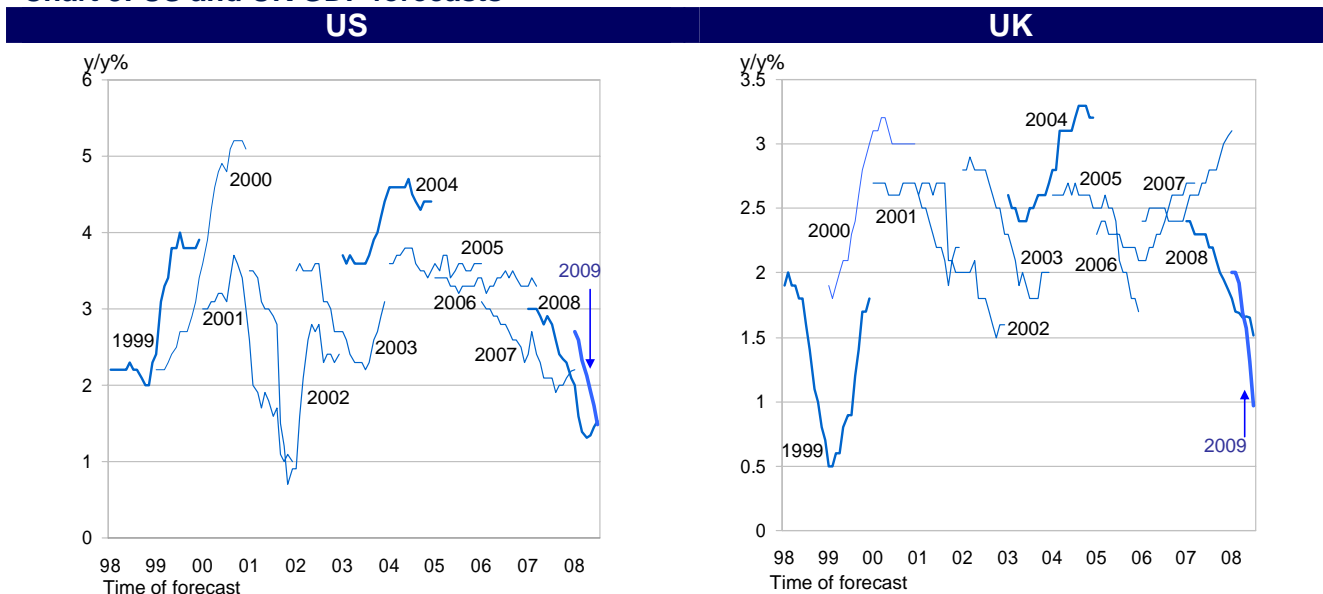
Source: Consensus Economics (Jul.), 2006 GDP weights, Schroders  
 Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore  
 Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand  
 Emerging markets: China, India, Indonesia, Malaysia, Philippines, South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



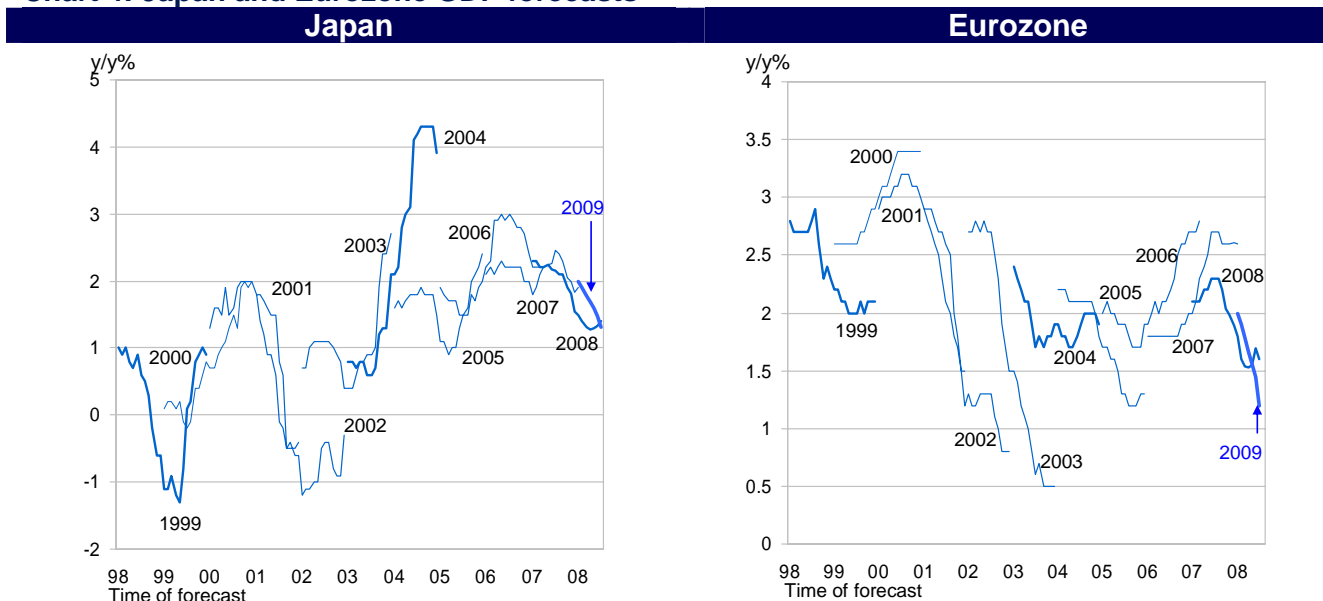
Source: Consensus Economics (Jul.), 2006 GDP weights, Schroders  
 Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore  
 Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand  
 Emerging markets: China, India, Indonesia, Malaysia, Philippines, South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

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



Source: Consensus Economics (Jul), Schroders

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