

Schroders

Economics and Strategy Viewpoint

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Global: The death of de-coupling? (page 2)

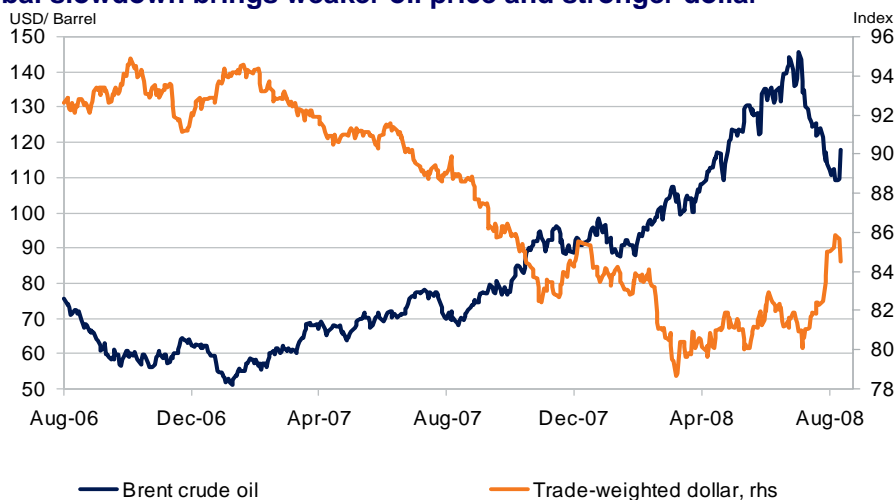
- There is increasing evidence that the US slowdown is spreading to the rest of the world with output in Europe and Japan falling in the second quarter. We would attribute this to the global impact of the commodity price shock combined with continuing effects from the credit crunch in Europe.
- From a market perspective, the principal beneficiary of this re-coupling has been the US dollar, which has staged a rally - a move that has occurred alongside a fall in oil and commodity prices (see chart below). Such declines have helped ease concerns about inflation.
- Lower inflation will help the world economy stage a modest recovery in 2009, but the emphasis is on the word modest and the fundamental problem for the US economy remains a lack of feed through from monetary policy to the interest rates paid by households and corporations. Judging from the widening gap between the steepening yield curve and the underperformance of the banking sector, the market would seem to take the same view.

Europe: UK economic outlook deteriorating rapidly (page 7)

- Our growth and inflation forecasts have been revised (downwards and upwards respectively) and so has our expectation for interest rates. Both the UK and the Eurozone are now likely to be entering recession, with the Eurozone first to record two negative quarters of growth starting in Q208.
- The UK in many ways is more vulnerable than the Eurozone region, given that the UK had a bigger credit boom, stronger house prices, strong domestic demand and a larger drop in savings in recent years. Nevertheless, the contraction in the Eurozone economy is also driven largely by the growing strain placed on the consumer given the collapse in housing markets, tighter bank lending conditions, high oil/food prices and the worsening labour market.

Forecast summary (page 11)

Global slowdown brings weaker oil price and stronger dollar



Source: Thomson Datastream



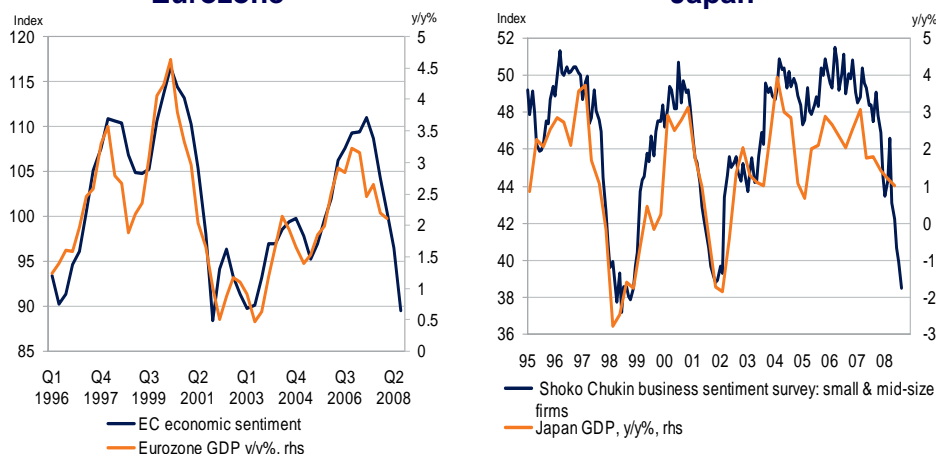
Global

Slowdown spreads beyond US

The death of de-coupling?

The world economy appears to be re-coupling as evidence increases of the slowdown spreading beyond the US. Both Europe and Japan recorded a fall in GDP during the second quarter and business surveys suggest that there is worse to come (see chart 1). In the emerging markets, activity is holding up better, but there are signs of moderation with leading indicators beginning to decelerate.

Chart 1: Surveys indicate sharp slowdown in Europe and Japan



Source: European Commission, Thomson Datastream

So is de-coupling dead? We would attribute the recent re-coupling to the global shock of rising oil and commodity prices, which have driven up inflation and squeezed spending around the world. The credit crunch has also played an ongoing role in some of the EU economies, particularly the UK and Spain where the housing market has slumped.

Looking at our own forecasts, we have downgraded European and Japanese growth on the back of a more pessimistic outlook for consumer spending. To the extent that the original argument against de-coupling was that a recession in the US would cause a recession elsewhere via weaker trade, the story is intact.

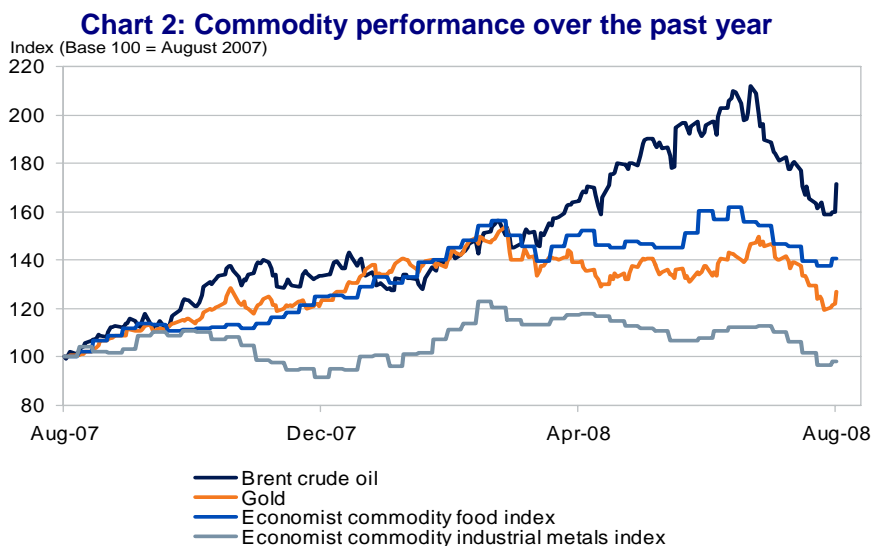
Nonetheless, putting such nuances to one side, we are now looking at a co-ordinated downturn in the OECD economies while the pressure on the emerging economies is mounting. In terms of changes in consensus, emerging markets are now in stagflation zone: forecasts for growth are falling while those for inflation are rising (see page 13 for details).

Inflation fears receding as commodity prices slide

Weaker global activity has played a part in pushing commodity prices lower and tempering concerns about inflation. Although headline CPI rates have pushed higher around the world with US inflation rate hitting a 17-year high in July, surveys show that fund managers have become less concerned about inflation.

This has been primarily driven by the easing in commodity prices with the oil price falling back from a peak of \$145 on 11th July to its current level of \$114/barrel (Brent crude). Evidence of demand destruction (US petrol consumption is now back to its 2003 level) and increased supply, as Saudi Arabia makes good on its pledge to raise output, have undermined the crude price. The commodity price decline is not confined to oil, food prices have also turned down as have industrial metals and gold (see chart 2).

Commodity prices have fallen across the board



Source: Thomson Datastream

Focusing on food and oil, the two most important commodities for inflation, should prices stay at current levels the impact on CPI indices will have faded to zero by the second quarter of next year. Given our view that core inflation will be stable or head lower in the major economies, this implies a sharp fall in headline inflation rates in 2009.

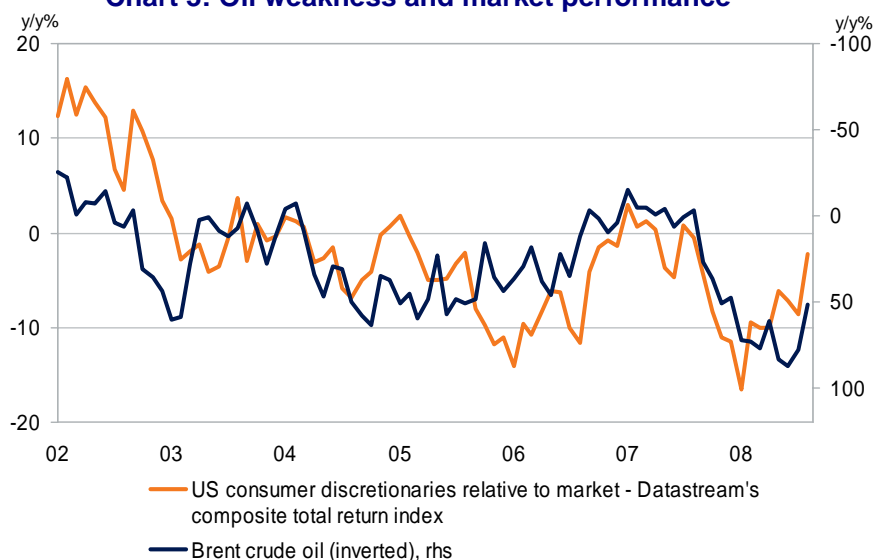
The benefits of a stronger dollar

Oil and the US dollar are moving in the right direction for risk assets

So far, the impact of global re-coupling has been most apparent in the foreign exchange markets where the US dollar has strengthened. Although US growth indicators remain depressed, the deterioration elsewhere has been greater making the US dollar relatively more attractive.

Drawing on the close relationship between oil and the dollar (see chart on front page), there is scope for a virtuous circle from a market perspective. The stronger dollar will have played a part in the fall in the oil price helping to damp fears of inflation. This in turn has reduced the pressure on policymakers to raise interest rates so helping to strengthen risk assets.

Lower oil prices also support hopes of a recovery in consumer spending, particularly in the US where movements in crude prices feed through rapidly to inflation and consumer real incomes. This is certainly how the equity market sees it with consumer discretionary stocks performing strongly during periods of oil price weakness (see chart 3 on next page). The circle is closed if international investors then see this as an opportunity to move into the US, thus boosting the dollar.

Chart 3: Oil weakness and market performance

Source: Thomson Datastream

Fannie & Freddie problems are adding to economic woes

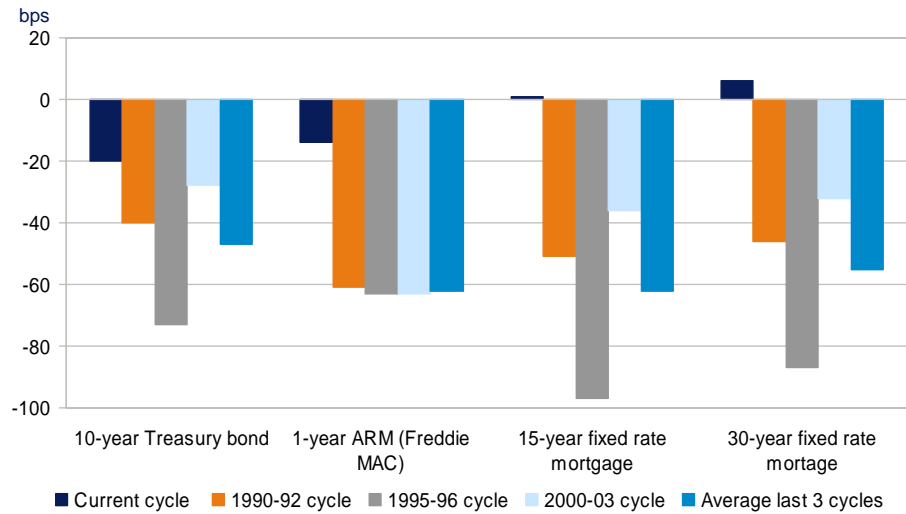
While oil prices and the dollar have been helpful for risk assets the re-emergence of concerns about the Government Sponsored Enterprise's (GSE's) Fannie Mae and Freddie Mac has had the opposite effect. The market is presently testing the resolve of the US Treasury to use its new powers and put equity into the GSE's.

This has led to a stand-off with the Treasury who believed they were only providing a backstop to the market, which in itself would be sufficient to generate confidence in the GSE's ongoing viability. Many now see Treasury action as inevitable and expect the government to effectively take over the GSE's.

This may prove to be the catalyst needed to turn the equity markets higher, however, in the meantime, it is increasing funding costs as investors are wary of providing capital to an enterprise on the verge of nationalisation. The adverse effect being that higher funding costs keep mortgage rates high thus hampering any potential recovery in the housing market.

We have highlighted the lack of feed through from policy changes by the Federal Reserve to mortgage rates in previous Viewpoint's. Updating this analysis shows there has been little progress on this front – a sharp contrast to previous easing cycles (see chart 4).

Chart 4: Response of bond yields and mortgage rates to 100bps Fed easing



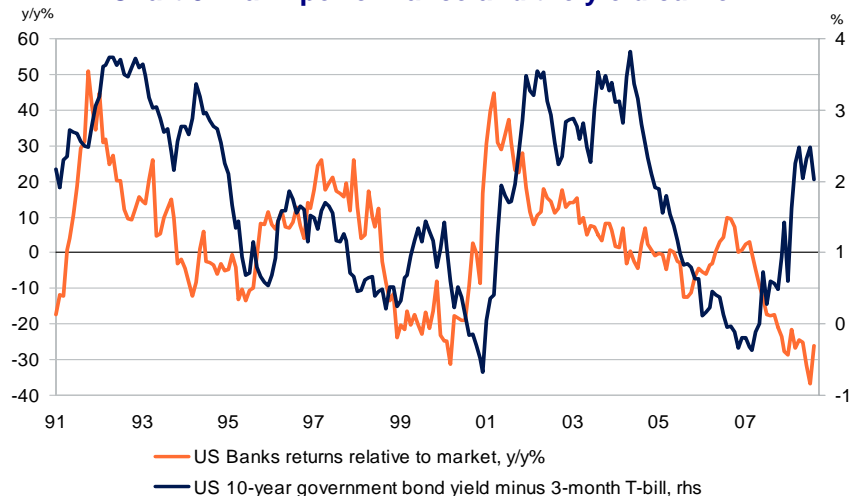
Source: Thomson Datastream, Schroders
 Note: Current cycle is from 17 September 2007 to 18 August 2008.

The lack of feed through from policy to the economy is clearly an obstacle to a recovery in the equity market and risk assets in general. The mechanism has been blocked by the increase in risk aversion by the banks who have continued to tighten lending conditions even though the Fed has cut short rates and provided a range of measures to improve liquidity. The latest Senior loan officer survey by the Fed confirmed that banks continued to tighten conditions since the last survey in April.

Bank shares not responding to the yield curve

Market doubts over the ability of policy to turn around the economy are reflected in the absence of any response from the bank sector to the steepening of the yield curve in the US. An upward sloping yield curve directly helps the banks, who exist to transform short term liabilities into long term assets and bank shares have tended to outperform when long rates have been above short (see chart 5).

Chart 5: Bank performance and the yield curve



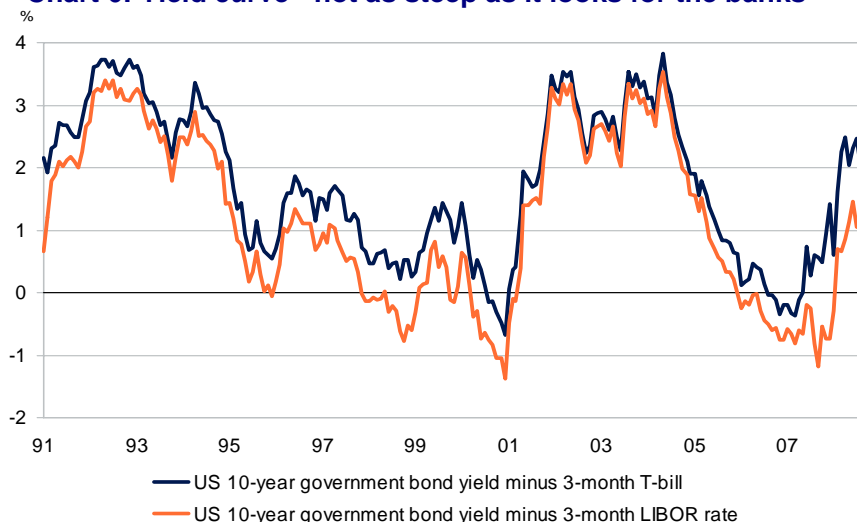
Source: Thomson Datastream



Following this line, it is often argued that the best way to recapitalise the banks is for the Federal Reserve to create an upward sloping yield curve such that the banks can make a near risk less turn by simply taking in deposits at the short end and buying Treasury bonds.

It would seem that in the current environment one reason why bank shares have failed to respond to this opportunity is the elevated gap between the level of interbank and policy rates. For example, the cost of three month interbank borrowing remains some 100 basis points (bps) above T-Bill rates (see chart 6).

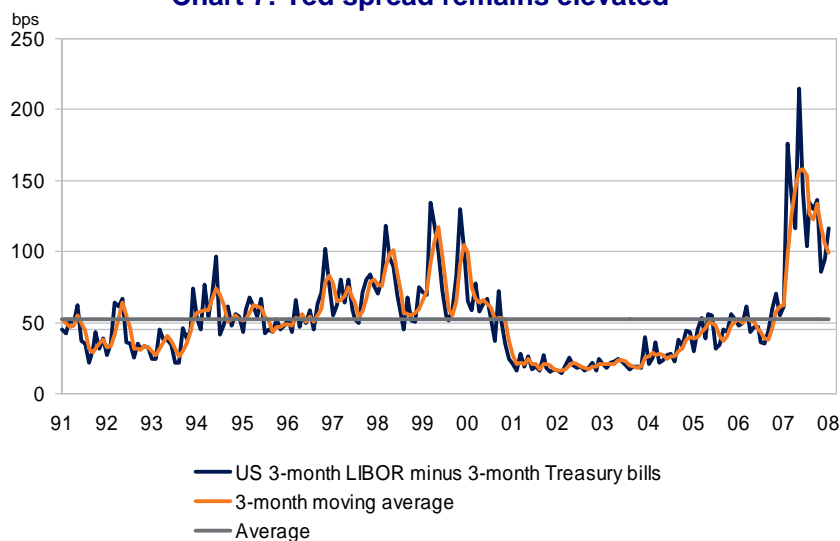
Chart 6: Yield curve - not as steep as it looks for the banks



Source: Thomson Datastream

Consequently, from the bank’s perspective the curve is not particularly steep at 100 bps. This suggests two things need to happen for a recovery in the financials and wider market. The first would be an even steeper yield curve with the gap between 10-year Treasury bonds and 3-month Treasury bills closer to 300 bps (rather than current 200 bps). Secondly, a narrowing of the gap between interbank and Treasury bills (know as TED spread) from its current level of 100bps towards it average of 50bps (see chart 7).

Chart 7: Ted spread remains elevated



Source: Thomson Datastream



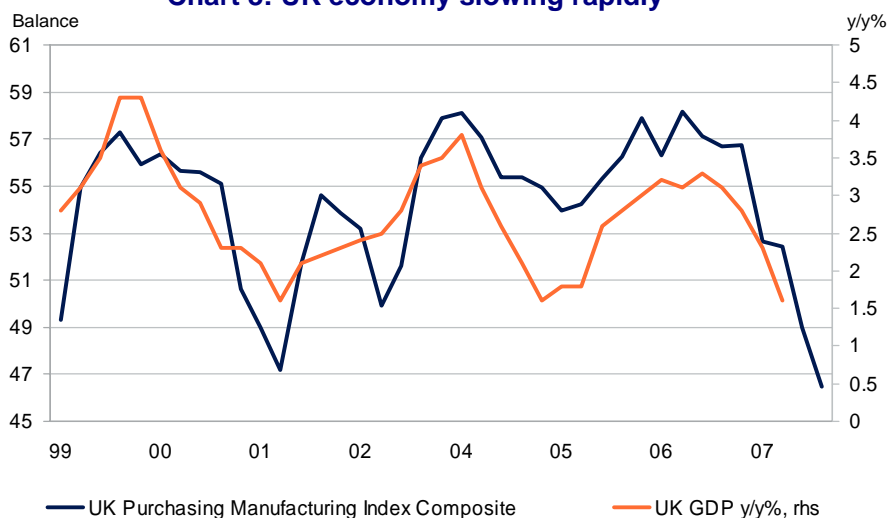
Europe

UK recession likely in the second half of this year

UK economic outlook deteriorating rapidly

Our view of the UK economy has been gloomy for some time but perhaps we have not been gloomy enough. We have therefore decided to revise our forecasts for both 2008 and 2009 to reflect growing weakness in the economy. Previously we had expected growth to turn out at 1.7% this year and 0.8% in 2009. Instead, our new projections show 1.2% for 2008 with weak growth extended to 2009 with growth at just 0.5%.

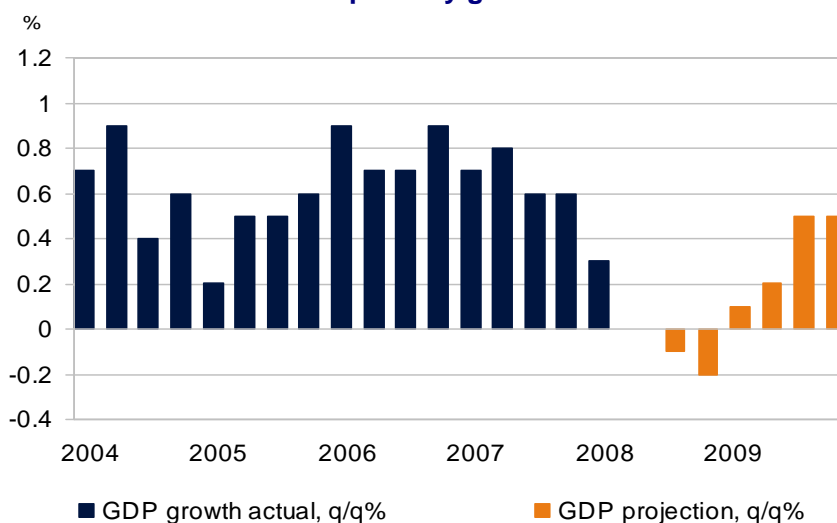
Chart 8: UK economy slowing rapidly



Source: Thomson Datastream

After 64 quarters of consecutive positive growth the UK economy is likely to record its first 2 negative quarters of growth Q3 and Q4 of this year with -0.1% and -0.2% respectively.

Chart 9: UK quarterly growth forecasts



Source: Thomson Datastream, Schroders

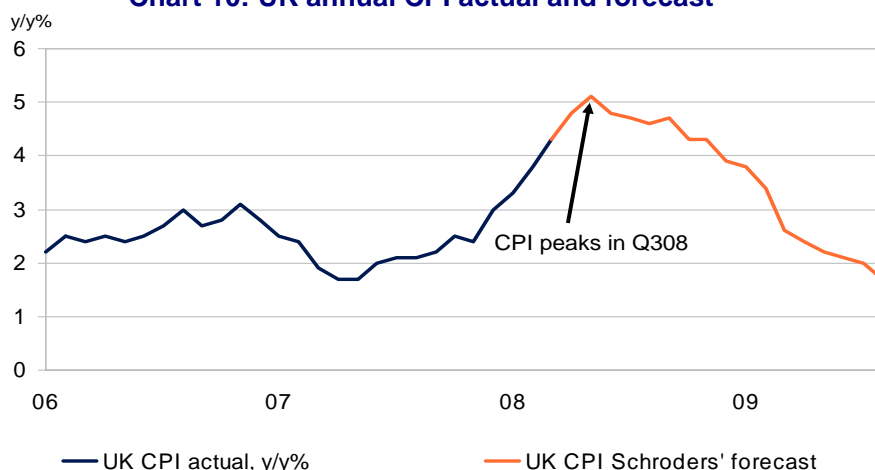
The UK economy's strong performance over recent years has been driven in part by strong government spending and big inflows of relatively skilled and low cost migrant labour. It has also been fuelled by credit driven spending and rising asset prices. The result is that the UK economy has been saddled with high private debts, low household savings, overvalued house prices and a weak fiscal position.

The UK in many ways is more vulnerable than the Eurozone region, given that the UK had a bigger credit boom, stronger house prices, strong domestic demand and a larger drop in savings in recent years. In many of the Eurozone countries the household savings ratios remain above 10% (16% in France) compared to just 1% in the UK. These combined factors make the UK economy more vulnerable to the credit crunch, which has intensified in recent months and shows little sign of abating in the near term.

Inflation peaks in Q308 and falls thereafter

At the same time, our inflation forecasts have also been revised upwards. Whereas we previously expected inflation to reach 3.1% in 2008 and 2.4% in 2009 we now see CPI reaching 3.8% and 3.1% over this year and next. This high number however masks significant improvements in year on year inflation over the course of 2009. While inflation on an annual basis now rises to 5.1% (due to utility bill increases) and peaks in September of this year inflation now falls to 1.7% by the end of next year. The slowdown in the economy as well as the recent fall in the oil price and other commodities helps inflation on its way down.

Chart 10: UK annual CPI actual and forecast



Source: Thomson Datastream, Schroders

Eurozone first to go into recession

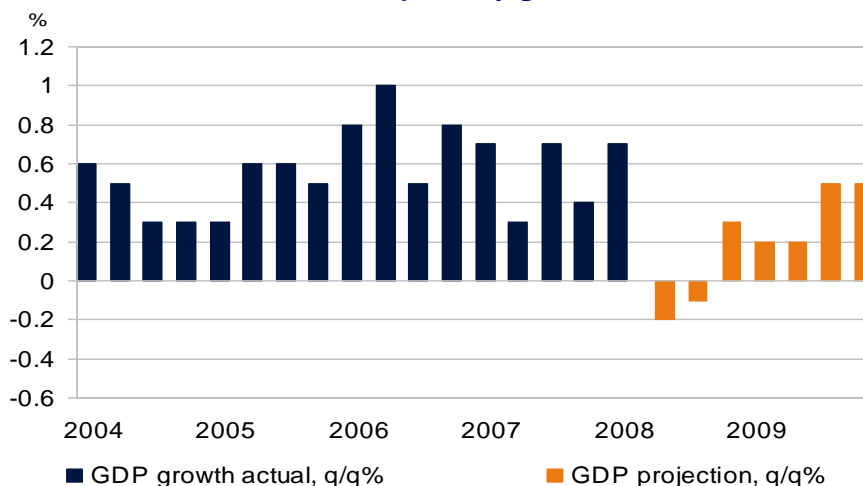
Our forecasts for the Eurozone have also been revised down. While the Eurozone did not experience the imbalances of the UK economy, the Eurozone is nevertheless likely to also experience a technical recession starting in Q208. The main reason for the downward revision to our growth forecasts is the growing strain placed on the consumer. The collapse in housing markets, tighter bank lending conditions, high oil/food prices and the worsening labour market will impact on activity and households' finances. Not surprisingly, recent retail sales numbers have been poor and point to a contraction in consumer spending. Even as the price of oil drops back, the consumer environment is likely to remain tight in coming quarters. If real incomes receive a boost from falling oil and food prices, consumer spending

is nevertheless likely to remain under pressure given that the labour market will have entered a downward trend in coming months with recent surveys showing that companies are already considerably revising their job plans; this shock to the consumer will be felt in every country of the Eurozone.

Eurozone first into recession

In the near term, after a strong Q108 of 0.7%, growth in Q2 is likely to be -0.5%, in part as a payback to Q1 but also because of the recent sharp deterioration in the data, both in exports and in the domestic economy. Weakness continues into Q3 where we expect growth at -0.1%. This sets the tone for 2008, where we now see growth at 1.1% with 0.9% next year, compared to 1.6% and 1.3% previously.

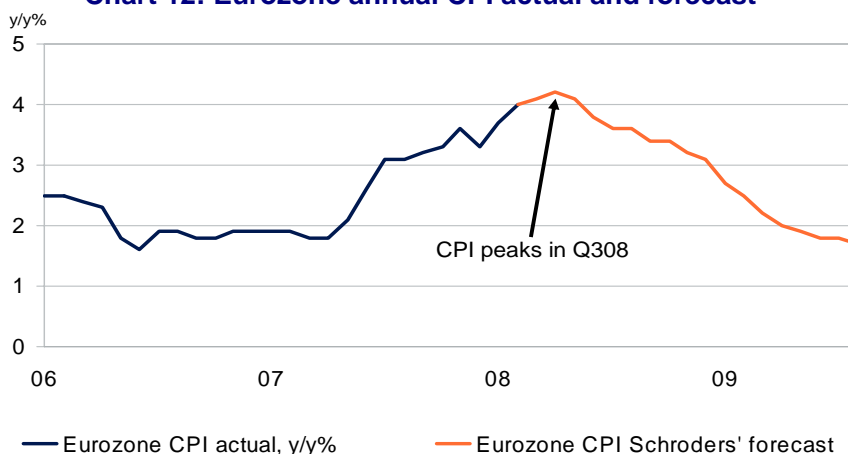
Chart 11: Eurozone quarterly growth forecasts



Source: Thomson Datastream, Schroders

And similarly to the UK, the inflation forecasts for the Eurozone have been revised upwards to take account of the oil price pass through. Previously, our forecasts were 2.9% and 1.8% for 2008 and 2009 respectively, compared to our new projections of 3.7% and 2.3%. As before, the peak in inflation is reached in Q308 of this year; importantly inflation on an annual basis falls to 1.7% by the end of next year.

Chart 12: Eurozone annual CPI actual and forecast



Source: Thomson Datastream, Schroders

Consequently, we have updated our forecasts for interest rates and now expect the BoE to cut to 3.5% (instead of 3.75%) by the end of 2009 with the first cut still expected towards the end of this year as we have argued in recent Viewpoints. For the Eurozone we also add an extra 25bp cut to leave the ECB at 3.5% by the end of 2009 with the first cut coming in March of next year.

Table 1: UK growth and inflation forecasts

UK	Old Forecast		New forecasts	
	2008	2009	2008	2009
Growth (y/y%)	1.7	0.8	1.2	0.5
Inflation (y/y%)	3.1	2.4	3.8	3.1

Source: Schroders

Table 2: Eurozone growth and inflation forecasts

Eurozone	Old Forecast		New forecasts	
	2008	2009	2008	2009
Growth (y/y %)	1.6	1.3	1.2	0.8
Inflation (y/y %)	2.9	1.8	3.7	2.3

Source: Schroders

Forecast Summary

I. Forecast summary - Schroders

Real GDP

y/y%	Wt (%)	2007	2008	Consensus	2009	Consensus
US	31.4	2.0	1.3	1.6	0.9	1.4
UK	5.7	3.1	1.2	1.4	0.5	0.9
Eurozone	25.3	3.0	1.2	1.5	0.8	1.1
Japan	10.4	2.0	1.2	1.3	1.3	1.2
Australia	1.8	4.1	2.7	2.8	2.5	2.6
OECD	74.6	2.5	1.3	1.5	0.9	1.3
China	6.3	11.6	10.2	9.9	8.5	9.2
Emerging*	25.4	7.5	6.3	6.4	4.9	5.9
World	100.0	3.8	2.5	2.8	2.0	2.4

Inflation CPI

y/y%	Wt (%)	2007	2008	Consensus	2009	Consensus
US	31.4	2.9	4.1	4.5	2.2	2.9
UK	5.7	2.3	3.8	3.6	3.0	2.9
Eurozone	25.3	2.1	3.7	3.6	2.3	2.5
Japan	10.4	0.1	0.7	1.4	0.5	1.0
Australia	1.8	2.3	4.0	4.4	3.0	3.3
OECD	74.6	2.2	3.5	3.7	2.1	2.5
China	6.3	4.6	6.5	6.9	4.5	4.7
Emerging*	25.4	5.2	7.0	8.0	5.6	6.1
World	100.0	2.9	4.4	4.8	3.0	3.4

* **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	3.00	2.00	3.61
UK	5.7	5.50	4.75	5.74	3.50	5.13
Eurozone	25.3	4.00	4.00	5.05	3.50	4.33
Japan	10.4	0.50	0.50	0.79	1.00	0.89
OECD	72.8	3.73	2.70	3.61	2.50	3.59

Market from forward futures strip as at

25/08/2008

Key variables

FX	Current	Dec-07	Dec-08	y/y%	Dec-09	y/y%
USD/ GBP	1.85	2.01	1.80	-10.7	1.76	-2.2
USD/ EUR	1.48	1.46	1.45	-0.3	1.50	3.4
JPY/ USD	109.3	112.5	110.0	-2.2	105.0	-4.5
GBP/ EUR	0.80	0.72	0.81	11.5	0.85	5.8
Brent crude	111.3	88.8	115.7	30.3	119.6	3.4
US output gap %GDP	-0.9	0.0	-1.8		-2.5	
Unemploy. %	4.9	4.8	5.9		6.6	

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

II. Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart 1: GDP consensus forecasts

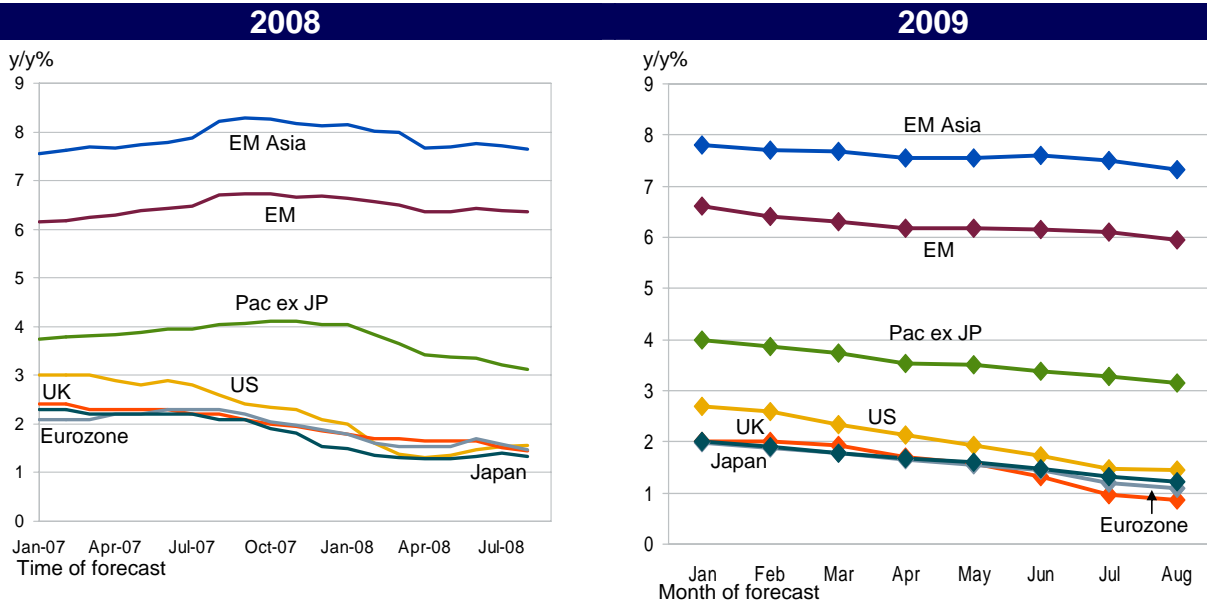
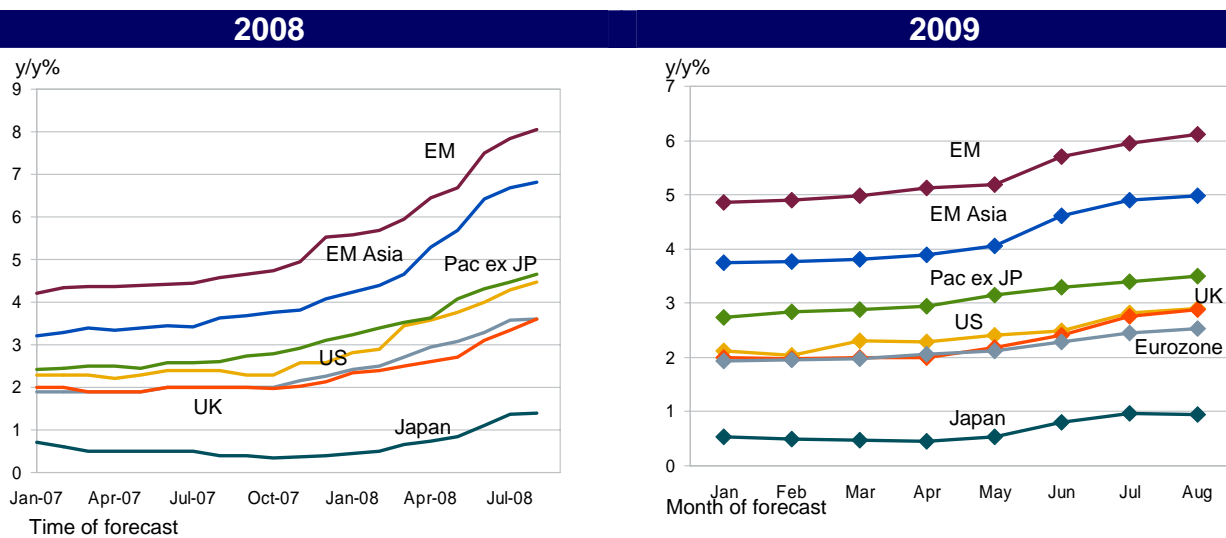


Chart 2: Inflation consensus forecasts



Source: Consensus Economics (Aug.), 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

II. Updated forecast charts - Consensus Economics

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Chart 3: US and Europe GDP vs. inflation forecasts

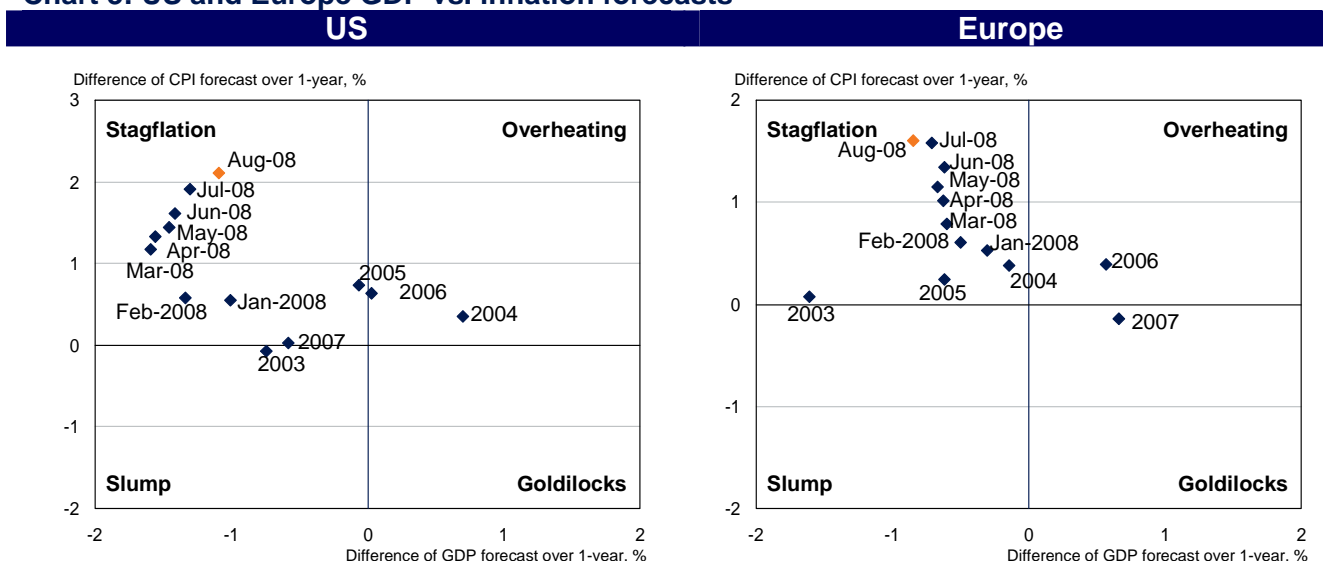
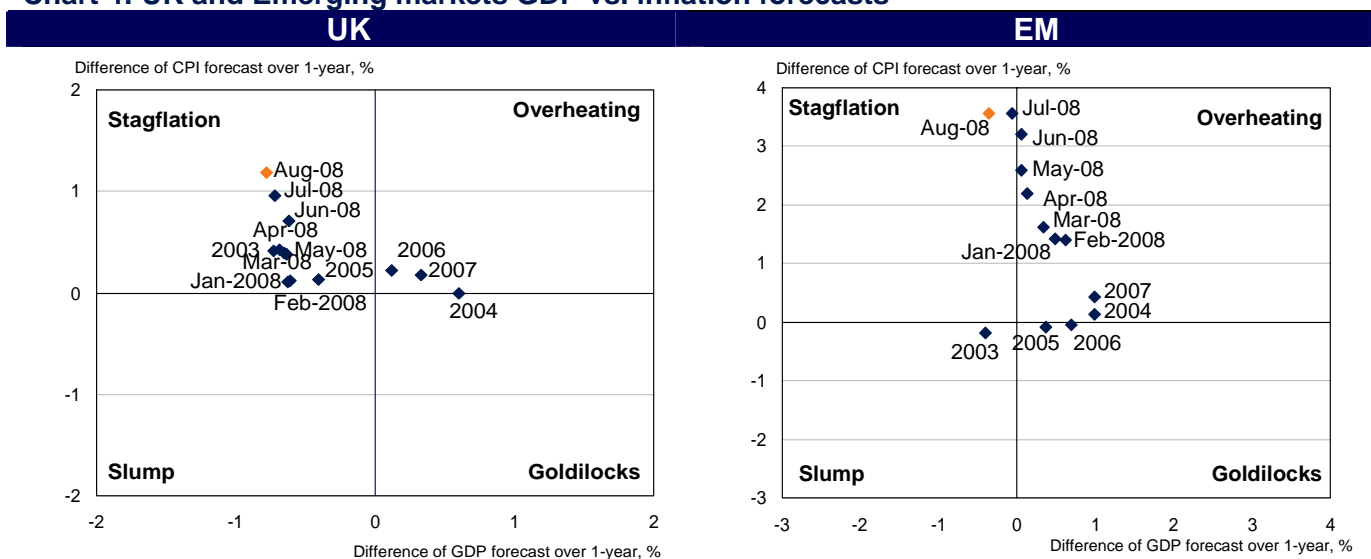


Chart 4: UK and Emerging markets GDP vs. inflation forecasts



Source: Consensus Economics (Aug.), Schroders

Note: Yearly figures for 2004-2007 are based on an average of monthly values.

Stagflation: Rising inflation and falling growth; Overheating: Rising inflation and rising growth; Slump: Falling inflation and falling growth; and Goldilocks: Falling inflation and rising growth.

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