

Schroders

Economics and Strategy Viewpoint

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Crisis update: Paulson's Plan is only the first step towards recovery (page 2)

- At the time of writing politicians in the US are still wrangling over the Troubled Asset Relief Plan (the TARP). The market has pinned its hopes on the TARP as the way out of the crisis and in our view it directly addresses the root of the problem. By ridding the banks of their toxic assets, interest rate spreads should narrow and monetary policy will become more effective.
- However, even if the TARP passes, depending on the price which is set for buying assets, it may still imply further write-offs and in some cases bankruptcy as losses are crystallised. Given the scale of the problem we may well need to see TARP 2 and markets will certainly need to be braced for more capital raising as the banks restore their balance sheets to a position where they are willing and able to lend again.
- Furthermore, the TARP addresses the supply side of the problem while ultimately recovery will require the demand for credit to rise. Falling house prices and rising unemployment suggest that households will not be rushing to gear up when the credit crunch eases. Look for rate cuts and even tax cuts as policy makers attention switches to boosting demand.

Research: Equity market drivers in the recession phase (page 3)

- Although the US banking crisis dominates sentiment it is useful to look back on previous cycles to identify the key drivers of a recovery in markets. In the past, the recession phase has seen strong returns from equity markets. Although earnings are falling in this phase of the cycle in the past investors have typically looked through the downturn to the recovery and re-rated the market.
- Obviously, the current outlook is so clouded with uncertainty that investors are struggling to see their way into next week let alone a possible trough in earnings in 2009. One factor, which should help sentiment in the near term, will be a peak in inflation paving the way for a more general easing of global monetary policy.

Forecast update

- We now expect the Fed to cut rates by 50 basis points at their next meeting on October 29th and are bringing forward ECB rate cuts to January from March. We still expect the Bank of England to ease in November.

Forecast summary (page 10)

The gap widens - interbank rate and T-bills



Source: Thomson Datastream



Global

Hopes pinned on Paulson's Plan

Crisis update: Paulson's Plan is only the first step towards recovery

Against a backdrop of rapidly moving events, the key to recovery now seems to lie with US Treasury secretary Hank Paulson's proposed \$700bn Troubled Asset Relief Plan (the TARP) which sits before Congress. There is little doubt in our view that by ridding the banking sector of its toxic assets, such a plan would help free up the system and start the credit mechanisms working again. In this respect, it is a necessary pre-condition for economic recovery. The failure of rate cuts by the Federal Reserve to feed through to the real economy can be largely attributed to the blockage in the banking sector which the TARP targets.

The stumbling block for the Plan at present is the price the authorities are prepared to pay for the assets, primarily illiquid Mortgage Backed Securities (MBS). Too low a price and the banking sector goes bust, too high and it is a simple bail out for the banks – bringing with it charges of socialism for the rich and reward for bad lending decisions.

Hank Paulson and Fed chairman Ben Bernanke are pushing for the bailout to be done at mark to model (or "hold to maturity" value) rather than mark to market prices. The latter are judged to be too low to elicit any sales as the banks may just as well file for bankruptcy. The former are treated with deep suspicion given that no private buyer is prepared to pay them.

At what price, market or model?

The issue here is that the assets in question are so unwanted that taken at face value market prices are discounting a major depression in the housing market. While there has been much talk of another Great Depression such an outlook remains a risk rather than a central view. More likely current prices reflect a dysfunctional market where extreme risk aversion has taken a total hold over buyers. Prices may not reflect reality, but no one is willing to take advantage.

On this basis, there is a case for government intervention: buying the securities now might ultimately yield a profit for the taxpayer once markets normalise. At present though such arguments do not hold much sway amongst many politicians, or a general public unclear on why the banks deserve to be exempted from normal market mechanisms.

The solution will balance moral hazard against the risk of systemic failure, but will probably combine a price the banks find acceptable with some mechanism which allows taxpayers to share more fully in the benefits of a successful rescue. An equity stake for the government would be one means of doing this. Some would also like to see caps on bankers pay and other forms of retribution.

In the meantime, the stress in money markets remains high with the spread between LIBOR (London Interbank Overnight Rate) and Treasury bills blowing out (chart on front page). This of course will only delay the recovery in activity further.

It is these spreads, along with those in SWAP and other credit markets, which we would expect to see narrowing as a result of a successful passage and implementation of the TARP. The hope though would be that this would provide the catalyst for a recovery as banks stop hoarding cash and put money into the economy allowing the normal credit creation process to kick in.

However, even if this can be achieved without further public money (TARP 2?), as described above this is pre-condition, not the end result. Depending on the price that is set for buying toxic assets, there may well be further write-offs and in some cases bankruptcy as losses are crystallised. Figures of \$500bn for the amount of capital banks will need to find are now being quoted. Consequently there will be further disruption in capital markets and it will take time before banks are sufficiently well capitalised to begin lending again.

Furthermore, we need to remember that all the recent efforts by the authorities are focussed on the supply side— i.e. to end the credit crunch. They do not address the demand side of the equation.

Stronger credit demand is also needed

Will the private sector be willing to borrow again when the credit crunch is over? On the household side there must be considerable doubt given that unemployment is rising and house prices falling in both the US and Europe. Many households believe they are over, not under, leveraged. There should be more scope on the corporate side where balance sheets have been kept in better shape. The risk here though is that investment spending tends to lag the cycle and consequently weakens with the rest of the economy, so reducing the demand for capital. The latest fall in orders for durable goods is a reminder of this.

Where does this leave us? It will be a significant step forward if the package before Congress gets through. However, we then expect the authorities to turn their attention from stimulating the supply to boosting the demand for credit that means more rate cuts, and possibly tax cuts, before recovery is on its way.

Research Note: Equity market drivers in the 'recession' phase

Although the outlook is currently dominated by events in the US banking sector the following note looks at recent market performance in the context of our cyclical asset allocation model. This is based on an analysis of economic cycles and market performance in the US since 1950 and is a key input into our asset allocation process. The purpose is to determine the similarities and differences between today and previous cycles and gain an insight into what needs to happen for risk assets to start performing.

According to the model, we moved into the recession phase of the cycle in June, a period which in the past has delivered strong performance from equities and risk assets more generally.¹

¹ Note that each phase of the cycle is defined by Schroders and does not necessarily correspond to official definitions of recession.

Since 1950 there have been nine recession phases in the US, equity returns have averaged nearly 10% ahead of cash and investors buying the market at the beginning of the phase would have made positive excess returns 88% of the time (table 1).

The 'recession' phase is normally associated with strong equity market performance

Table 1: Performance of equity markets by phase of cycle (% p.a.)

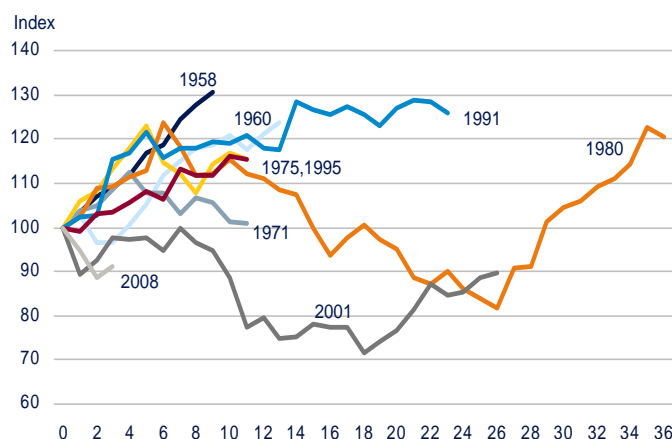
	Recovery	Expansion	Slowdown	Recession
Excess return	8.6	8.8	-8.1	9.9
Volatility	13.7	12.4	17.4	14.6
% beat cash	100	83	22	88

Excess return is annualised return on S&P500 over cash. Source: Schroders

In the past investors could reliably make money by switching to equities during the recession phase. The question then is why should this time be different?

Looking more closely, the chart on the next page shows the performance of US equities in each recession phase since 1958. It may be early days but at present, the current cycle has the worst performance of any recession including the 2001 cycle. The other seven phases have been comfortably ahead at this stage.

Chart 1: US Equity market performance in the recession phase (return over cash)

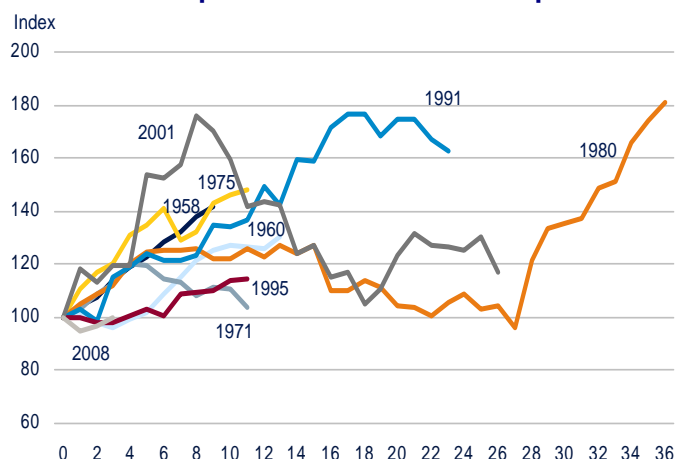


Source: Schroders

Returns are driven by a re-rating of the market as earnings fall

Breaking returns down into rating and earnings growth we can see that there has been no re-rating of the equity market at this point, a characteristic shared by only two previous cycles (chart 2 on next page). Otherwise, markets have consistently re-rated during the recession phase. The lack of re-rating in the current cycle is surprising given that the valuation of the US market does not seem stretched by past standards (we examine this in more detail below).

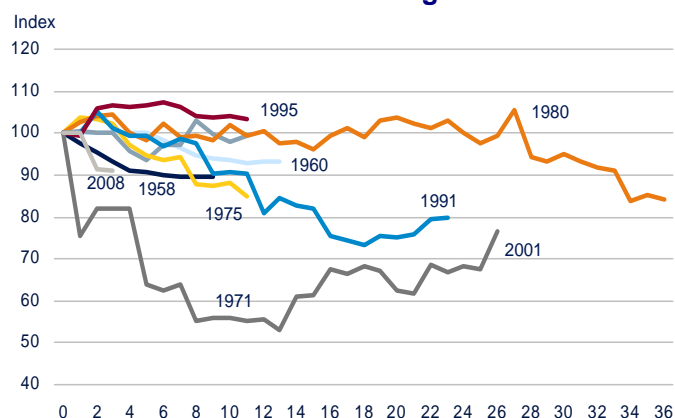
Chart 2: PE expansion in the recession phase



Source: Schroders

The other source of return is earnings growth. On this front, the fall of nearly 10% in the current cycle is relatively poor and has only been beaten on the downside by the 2001 experience. However, it is a general characteristic of the recession phase that earnings fall as economic activity weakens (chart 3).

Chart 3: The recession phase compared – Market earnings per share growth



Source: Schroders

Investors normally look through the downturn in the recession phase

Sources of return in the recession phase

Pulling this together, the source of return during the recession phase is the ability of the equity market to re-rate faster than the decline in earnings. Coming after the slowdown, the recession is the point at which investors recognise that earnings are coming down, but are prepared to look through to the trough and the eventual recovery. This phase is often characterised by relatively high trailing PE's as there is a lag before the improvement in earnings comes through.

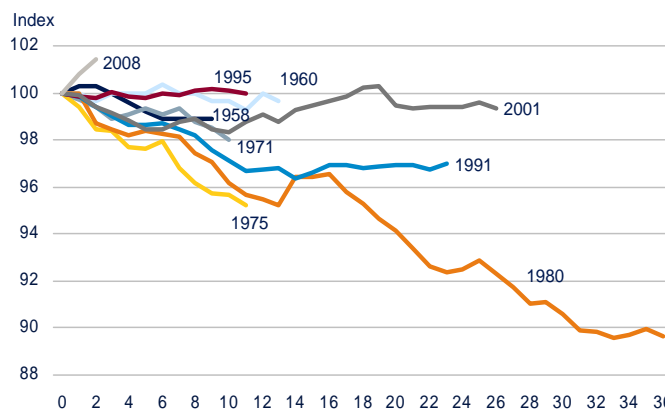
Not surprisingly, recessions are also characterised by relatively high volatility as they require investors to make a judgement about future earnings and whether these are adequately priced. Such a view is harder to form when earnings are falling and the economy appears to be diving off a cliff.



This brings us back to the current cycle. In our view, the current level of equity valuations is fair relative to the past or to bond yields. It is the lack of confidence in future earnings which is undermining the market.

One factor, which has made the assessment of earnings more difficult, has been the inflation cycle. In every other recession phase, inflation has been falling at this point. This time it has been rising (chart 4). Clearly declining inflation helps investors look through the downturn as it paves the way for easier monetary policy and recovery. We will not re-visit the debate about the outlook for inflation, but suffice to say that we do expect this obstacle to be removed as inflation peaks toward the end of the year.

Chart 4: The recession phase compared: cumulative y/y% change in CPI



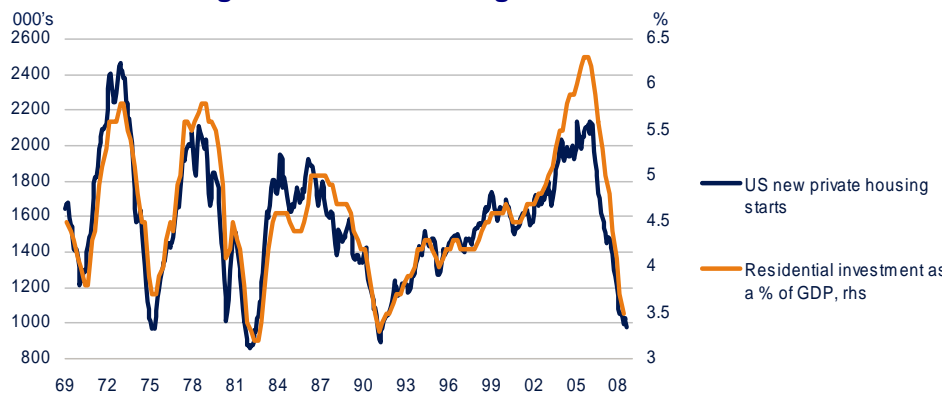
Source: Schroders

Seeking clarity on earnings

Confidence in future earnings is weak at present reflecting persistent doubts about the financial sector and the impact this will have on the rest of the economy. Analyst forecasts are little help, relying heavily on short-term guidance from companies.

Our central view assumes a modest recovery in activity as housing troughs and inflation falls in 2009 (chart 5). However, the visibility is clouded by the ongoing crisis in the financial sector and the risk of a credit crunch.

Chart 5: Housing starts close to trough...



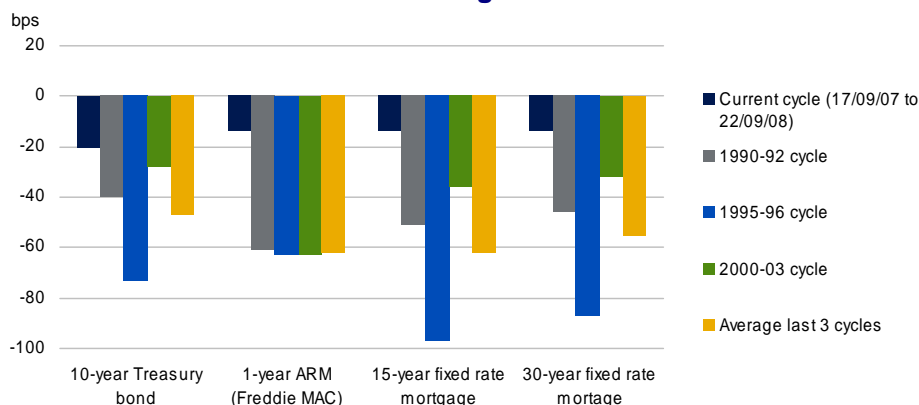
Source: Thomson Datastream



In terms of the wider economy, the real drag from the financial sector is the way it is inhibiting the monetary policy transmission mechanism and is the motivation behind the proposal by the US Treasury to buy \$700 billion of 'troubled' assets from the banks. An example of this is lack of feed through from lower interest rates at the Fed to the mortgage rates paid by homeowners (chart 6).

Limited feed through from rate cuts by the Fed to the housing market

Chart 6: Response of bond yields and mortgage rates to 100bps Fed easing

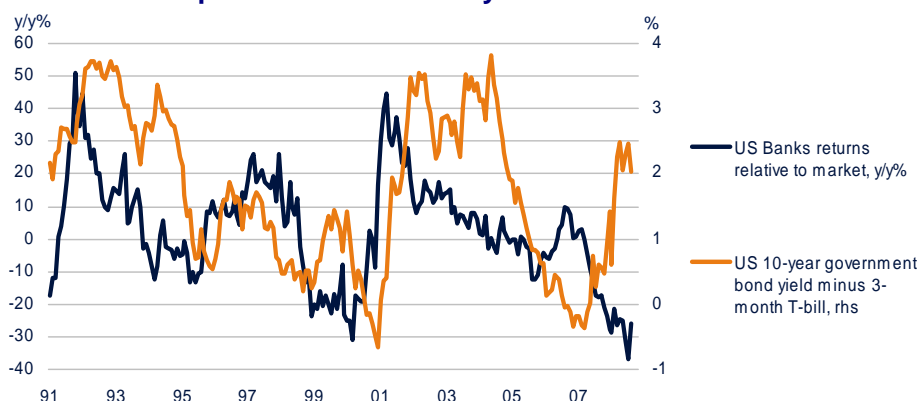


Source: Thomson Datastream, Schroders

The problems stem from the ongoing level of spreads between inter-bank lending and policy rates. These are elevated, thus increasing the bank's cost of capital. This is preventing mechanisms such as the steepening of the yield curve from feeding through into a better outlook for the banking sector (chart 7).

These factors reduce the visibility of the earnings cycle by delaying the feed through from monetary policy to the economy. In our view, they reinforce the view that interest rates will remain low for some time and even suggest that the Fed may cut rates again in an effort to steepen the yield curve and help the banks. We now expect the Fed to cut by 50bps before the end of the year.

Chart 7: Bank performance and the yield curve



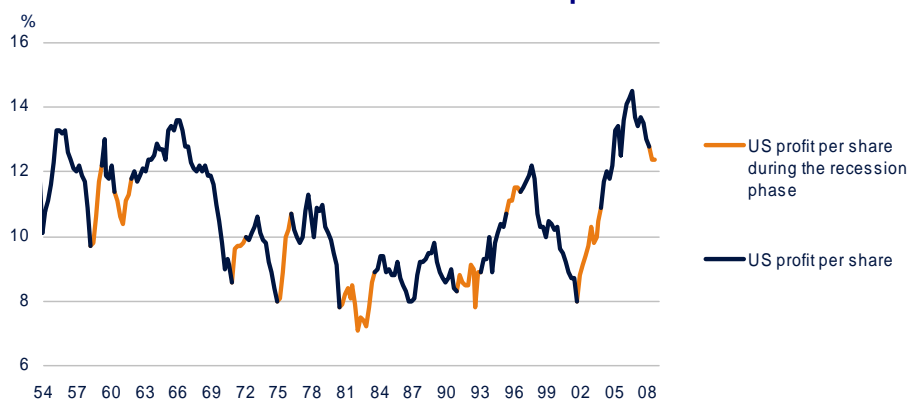
Source: Thomson Datastream

Some earnings arithmetic

So how far could earnings decline in this cycle? From a top down perspective, earnings growth can be broken into the change in nominal GDP and the profit share in GDP (sometimes known as the profit margin). A downturn in economic activity clearly slows the former, but the real swings in profits are driven by the latter.

From this perspective, another key difference between this recession phase and others is that the profit share is starting from a relatively elevated level. On previous occasions, the economy has entered the recession phase with profits at historic lows, a point from which they have subsequently risen. This time they are elevated and falling (chart 8).

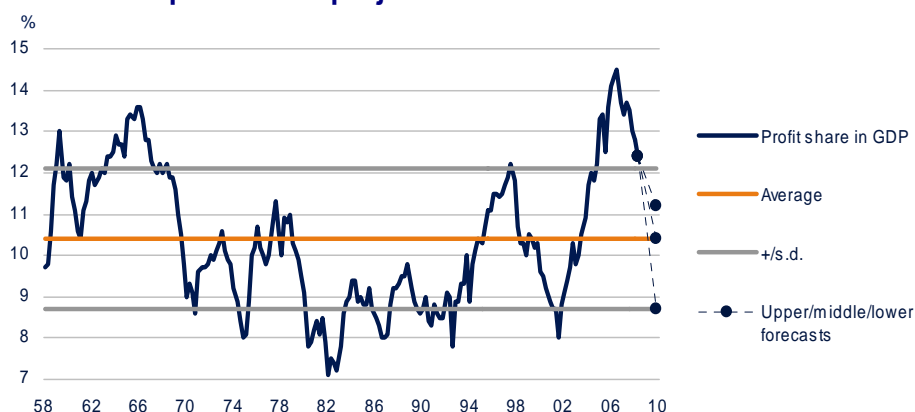
Chart 8: Profit share and the “Recession” phase



Source: Thomson Datastream, Schroders

This suggests that the hit to earnings may be greater this time as earnings suffer from the geared effect of falling margins. We have calculated potential falls in profits on different assumptions about the profit share currently 12.4% of GDP. These are an upper case of a modest fall to 11.4, a return to mean (middle forecast) and a lower forecast (a return to one standard error below mean).

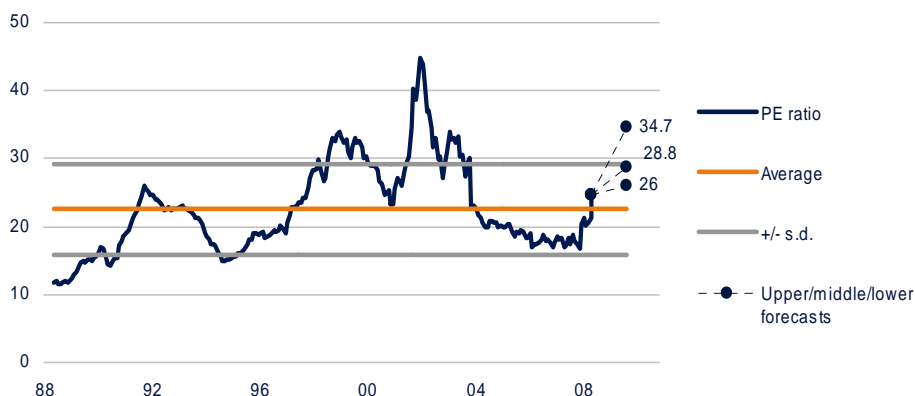
Chart 9: US profit share projections



Source: Thomson Datastream, Schroders

Adjusting for changes in nominal GDP these result in falls in earnings of 5%, 14% and 29% respectively. In terms of the impact on the market rating this would take the PE on the S&P500 (currently just under 25) to 26, 29 and 35 (chart 10).

Chart 10: PE projections



Source: Thomson Datastream, Schroders

Conclusion

So where does this leave us on the outlook for equities and risk assets? That equities are not performing as the model suggests should not be a huge surprise. Markets do not behave according to a set of formulae.

Lower inflation and earnings visibility are needed to turn risk assets

However, the cyclical model does provide a robust framework for assessing markets and points to the factors which will be important for future performance. On this basis, markets need to become more confident on two scores if we are to see a stronger performance from equities. The first is a turn in inflation, which we believe, should occur before the end of the year and is now imminent in most economies. This in itself will help support growth through the boost to consumer and corporate spending power. Lower inflation will allow central banks to cut interest rates without fear of losing credibility.

Second, we need greater visibility on earnings. There is a risk that we see a 30% fall from here, which would push the PE up significantly. However, it is unlikely in our opinion. There is strong evidence that the profit share will fluctuate within a higher band going forward reflecting gains in productivity and the benefits of globalisation. A return to previous troughs is unlikely.

The greater concern is the lack of stimulus from monetary policy. This underlies our forecast of a weak recovery in growth accompanied by an extended period of low central bank interest rates and, no doubt, a loose fiscal policy.

Forecast Summary

I. Forecast summary - Schroders

Real GDP

y/y%	Wt (%)	2007	2008	Consensus	2009	Consensus
US	31.4	2.0	1.5	1.8	1.0	1.4
UK	5.7	3.1	1.2	1.2	0.5	0.6
Eurozone	25.3	3.0	1.2	1.3	0.8	0.9
Japan	10.4	2.0	1.2	0.9	1.3	0.9
Australia	1.8	4.1	2.7	2.6	2.5	2.6
OECD	74.6	2.5	1.4	1.5	1.0	1.1
China	6.3	11.6	10.2	9.9	8.5	9.1
Emerging*	25.4	7.5	6.4	6.3	5.0	5.8
World	100.0	3.8	2.6	2.7	2.0	2.3

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	3.8	3.0	2.9
Eurozone	25.3	2.1	3.7	3.5	2.3	2.4
Japan	10.4	0.1	0.7	1.6	0.5	1.2
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	6.8	4.5	4.6
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	1.50	3.39	1.50	3.52
UK	5.7	5.50	4.75	6.05	3.50	5.22
Eurozone	25.3	4.00	4.25	5.24	3.50	4.59
Japan	10.4	0.50	0.50	0.88	1.00	0.98
OECD	72.8	3.73	2.57	3.88	2.28	3.66

Market from forward futures strip as at

23/09/2008

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	1.47	1.46	1.45	-0.3	1.50	3.4
JPY/ USD	105.8	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	102.0	88.8	115.7	30.3	119.6	3.4
US output gap %GDP	-0.9	0.0	-1.7		-2.5	
Unemploy. %	5.3	4.8	5.9		6.6	

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

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

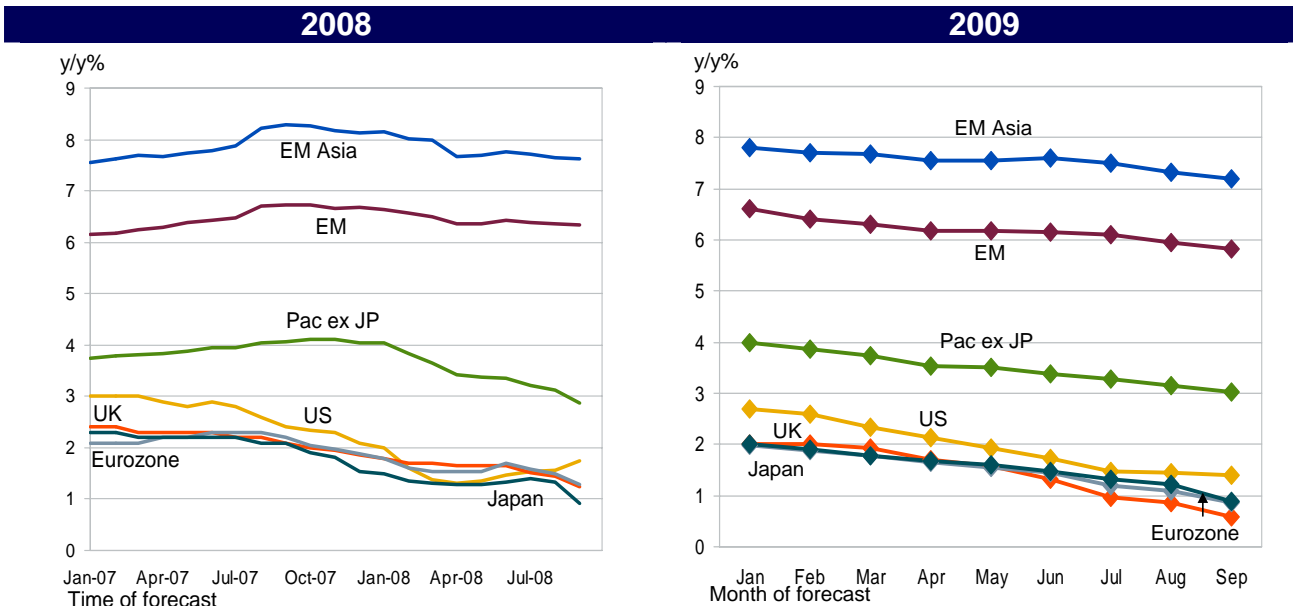
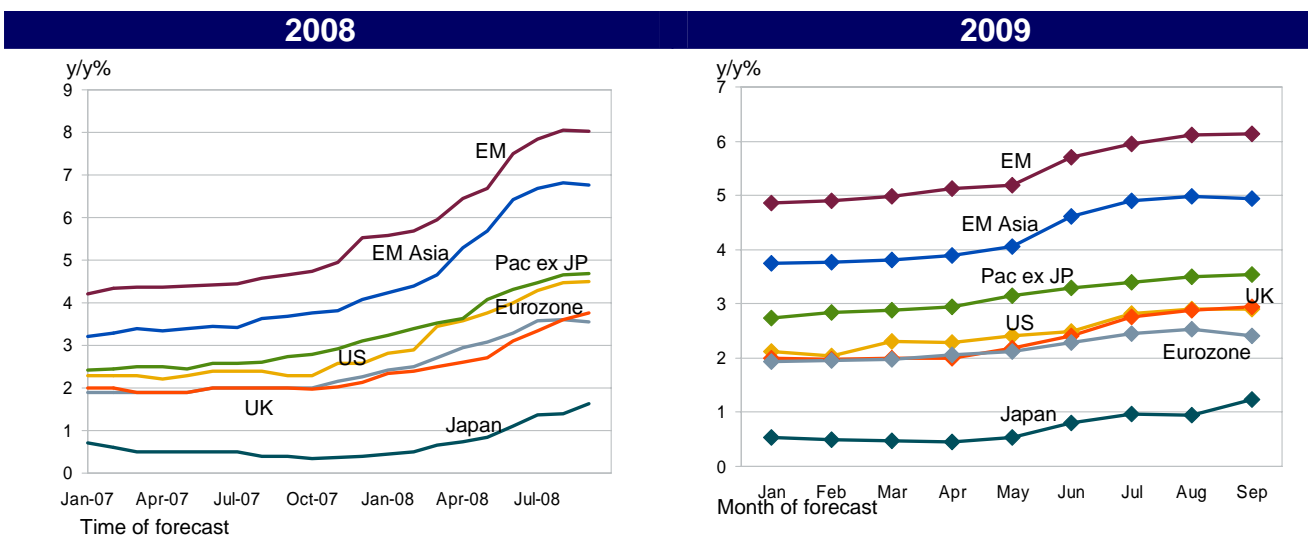


Chart 2: Inflation consensus forecasts



Source: Consensus Economics (Sep.), 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

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

Chart 3: US and Europe GDP vs. inflation forecasts

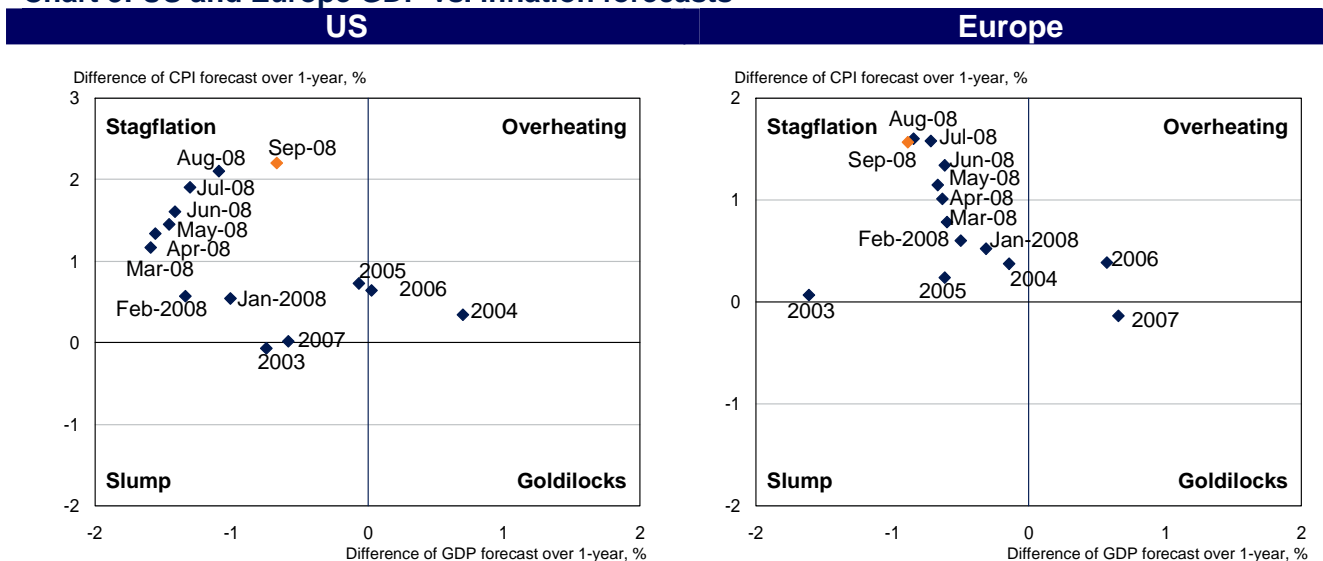
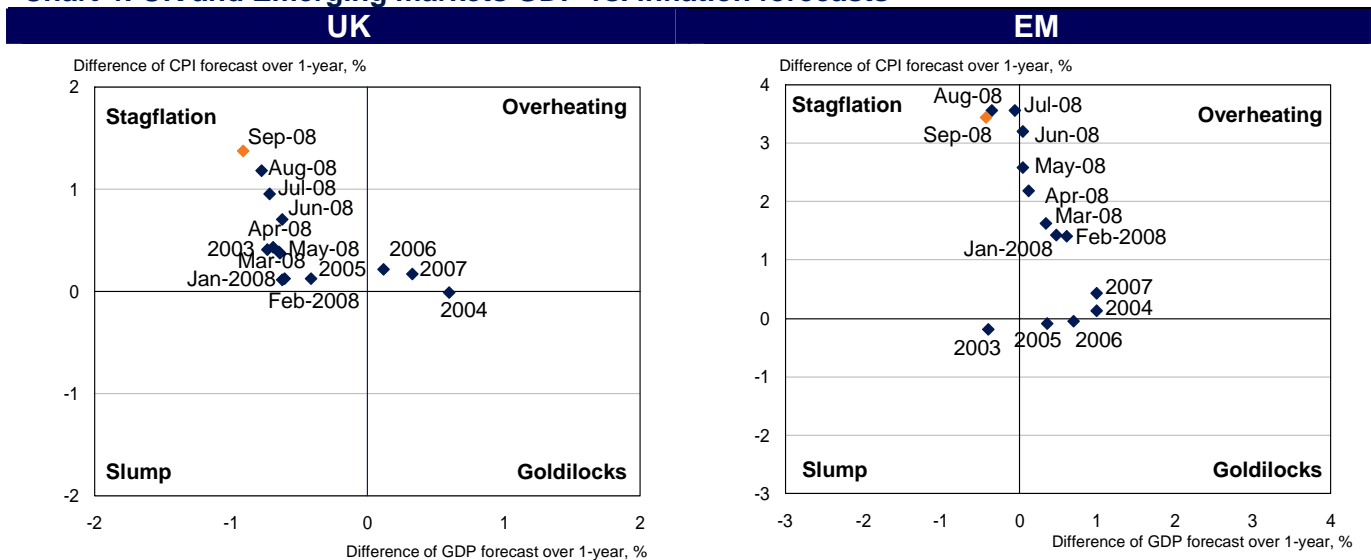


Chart 4: UK and Emerging markets GDP vs. inflation forecasts



Source: Consensus Economics (Sep.), 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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