

Schroders

Economics and Strategy Viewpoint

Keith Wade

Chief Economist and Strategist
(44-20)7658 6296

Tina Fong

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

Harish Vekaria

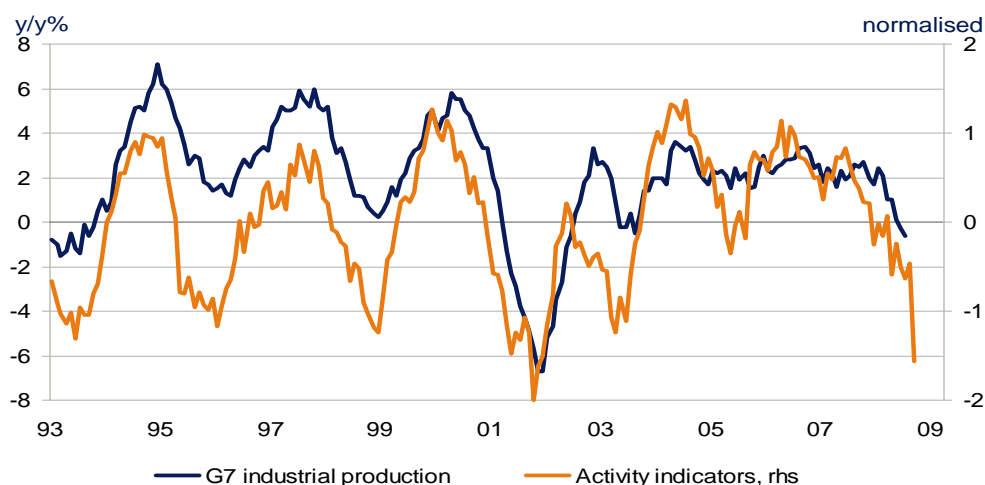
Quantitative Analyst
(44-20)7658 2722

Credit crunch to bring global recession in 2009 (page 2)

- The intensification of the credit crunch has led us to cut our growth forecasts for 2009. We now expect the OECD economies to experience a contraction in output next year. Consumers are under pressure from the tightening of credit and falling asset prices while the latest surveys signal a fall in industrial output (see chart).
- Inflation and interest rates will fall further than previously expected. The slack created by the recession combined with the fall in commodity prices should take OECD inflation below 2% next year. Interest rates in the UK and Euro area are forecast to fall to below 3%.
- No doubt the deterioration in the economic outlook accounts for some of the recent weakness in equity and credit markets. Lack of earnings visibility going forward is keeping investors cautious. However, equities and credit already seem to be discounting a recession or worse, and we would also attribute weaker markets to the presence of sellers who are being forced to realise cash.
- Our asset allocation remains underweight equities although we recognise that an opportunity to add may not be far away. Putting aside the issue of forced selling, an improvement in earnings visibility will be an important step in encouraging a more positive stance on risk assets. That in turn will require evidence that monetary policy is being allowed to feed through to the real economy as the money and credit markets begin to thaw.

Forecast summary (page 6)

Activity Indicator signals sharp downturn



Source: Schroders, Thomson DataStream



Global

Credit crunch to push global economy into recession

The intensification of the credit crunch since September has led us to downgrade our growth forecasts. We are now expecting a global recession with the US, UK and Eurozone experiencing a decline in output in 2009.

Tighter bank credit is being felt in both the household and corporate sectors. On the consumer side, retail sales in the US have fallen for the past three months while in the UK we saw a sharp fall in September. Falling house prices and rising job insecurity have caused consumer confidence to plunge to levels last seen in the early 1990s.

Recession forecast for 2009, led by weaker consumer spending

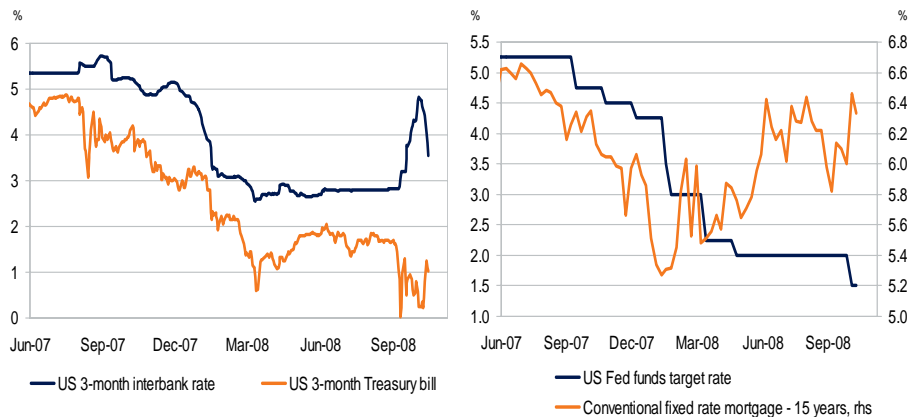
Meanwhile, the purchasing managers indices have also fallen sharply and our activity indicator is consistent with recession (see chart front page). The downturn is also being felt in China where GDP growth slowed to 9% in the third quarter down from 11% a year ago. More significantly, the decoupling theme has been dealt a fatal blow by the recent crisis in emerging market currencies. The carry trade is unwinding and those countries with current account deficits have been badly affected as investors question their ability to attract future funding.

Europe will be badly hit by the problems in Eastern Europe, an important export market. More generally, trade is under pressure as banks withdraw letters of credit and the Baltic Freight index has collapsed.

The question now is how will the recession compare with previous experience? History shows that downturns caused by a systemic banking crisis are deeper and longer than a "standard" downturn. In a recent study of 42 crises by the IMF, the average loss in GDP relative to trend was 4% and the duration of the downturn 2½ years – about twice the norm.

The problem in a banking crisis is that the transmission mechanism from monetary policy to the economy becomes blocked by the dislocation in the financial sector. For example, 15-year mortgage rates are similar to when the Fed started cutting rates (chart 1). It is difficult to see the housing market stabilising in the US without lower mortgage rates.

Chart 1: Money market rates ease, but mortgage rates remain high



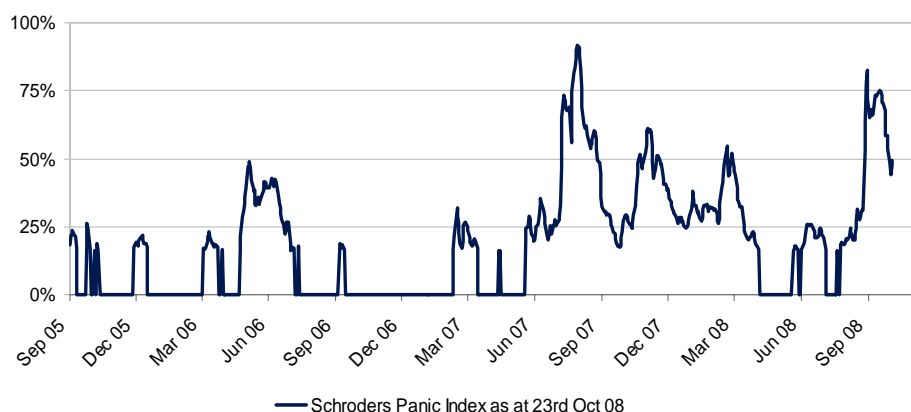
Source: Schroders, Thomson DataStream

Market remains in panic mode, keeping the cost of capital high

Action taken by the authorities to recapitalise the banking sector should overcome this and the IMF study referred to above found that this was the solution in 32 of the cases studied. Indeed there is evidence that the medicine is working with LIBOR and SWAP spreads narrowing in recent days. However, spreads remain at elevated levels and in securities markets have continued to widen while volatility remains high. The overall conclusion is that there is some evidence of an easing, but the cost of capital remains elevated.

This is reflected in Schrodgers panic index¹ which has come down from the levels of a month ago, but is still high.

Chart 2: Schrodgers Panic Index



Source: Schrodgers

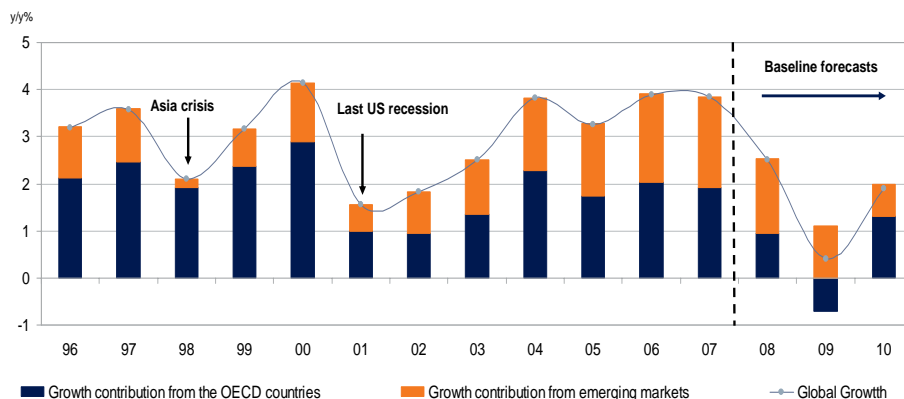
Our outlook is for GDP to fall by 1.5% in the US and 2% in the UK next year and by ½ % in the Eurozone. Emerging market growth is expected to slow to 4% from over 6% this year. This results in a fall in OECD GDP in 2009 which would be the worst outcome on records starting in 1970.

One reason for this is the co-ordinated nature of the downturn with all economies being affected to some degree. In the past there was some degree of desynchronisation with one region or economy offsetting weakness elsewhere. The most comparable period for the OECD is the recession of the early 1980s – on a global basis though the outlook is not as bad as the emerging economies are stronger today than they were 25 years ago.

On a more positive note, the slack created by the recession combined with the fall in commodity prices results in a significant improvement in inflation. OECD inflation forecast to fall to under 2% in 2009. When combined with loose fiscal and monetary policy this should allow a modest recovery in 2010.

¹ The index captures the spread on a range of money market and credit instruments as well as sentiment indicators. The series are normalised and weighted to produce the index - more details available on request

Chart 3: Global Growth Forecast



Source: IMF, Consensus Economics, Schroders

Markets: deteriorating fundamentals and dysfunctional markets

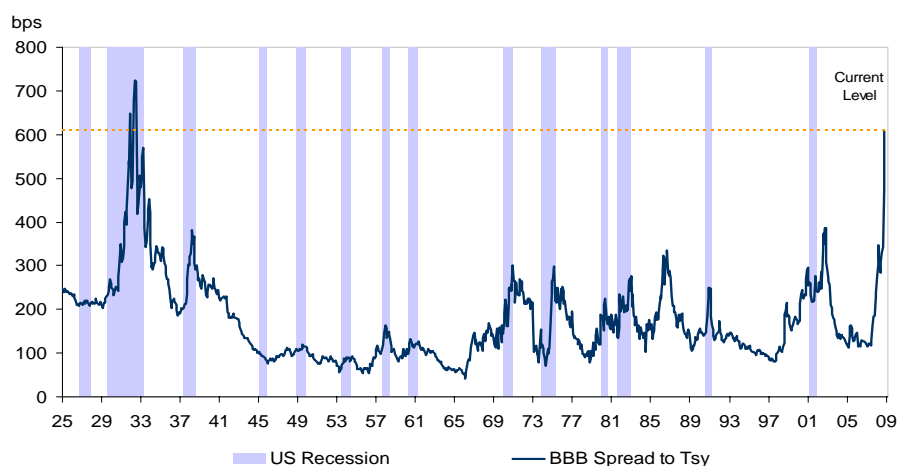
Explaining the weakness in markets

The popular perception is that the fall in financial markets can be directly attributed to the deterioration in the global outlook. Or as some would have it the onset of recession in the UK – “FTSE in free fall as UK economy crashes”².

Certainly, the deterioration in the outlook has been dramatic and will have played a part in the weakness, but it would be surprising if markets were solely reacting to an event that has been on the cards for some time. Indeed, our analysis of previous cycles suggests that markets have normally discounted much of the bad news by this stage and are beginning to rally as investors look through the downturn to the recovery.

Given the prevalence of single digit PE ratios, dividend yields above government bond yields and credit spreads at levels last seen more than sixty years ago (Chart 4), valuations do not seem to be the problem.

Chart 4: Credit Spread at levels last seen in 1930's



Source: Morgan Stanley, Moody's, NBER, Thomson DataStream, As 24th Oct 2008

² Evening Standard 24th October 2008

In our view two factors help explain the current weakness in markets.

- The first would be a continuing lack of visibility. The credit crisis has had the look of a slow motion train wreck: investors can see the damage but do not know where it will end. Although few are calling for a slump on the scale of the Great Depression it remains a risk that few are willing to bet against.

The difficulty is that no one knows how far and for how long the de-leveraging process needs to play out. If as some argue the US savings rate will rise to 10%, consumption would fall 8% and GDP 6%, all things being equal. Depending on the timescale this would result in a major recession or an extended period of sub trend activity.

In addition the journey to a world with less private debt and a smaller banking sector is strewn with pitfalls which can push the world economy onto a new path of even lower output and activity. For example, the US government fell into one of these by allowing the bankruptcy of Lehman to encompass assets previously regarded as safe such as senior debt. This triggered the surge in risk aversion which is with us today and added another turn to the credit crunch screw.

Going forward, it is our view that government action in terms of re-capitalising the banks, offering guarantees on deposits along with the prospect of easier fiscal policy will support activity. However, it may be some time before markets have the visibility to bet on this.

- The second, is the dislocation of markets. The de-leveraging process is hitting the hedge fund world hard. Banks and brokers are tightening or even withdrawing their credit lines to hedge funds which in several cases are being liquidated. The need to then dispose of assets is weighing on the markets, pushing prices down and volatility up.

From the perspective of the long only investor such an explanation suggests that better times lie ahead as once the selling pressure has abated there will be a tremendous buying opportunity. This may be so, but in the meantime there is the danger that falling prices cause others to start to sell either because they have hit levels at which they are obliged to reduce their holdings or out of sheer panic.

Conclusion

Our asset allocation remains underweight equities although we recognise that an opportunity to add may not be far away. Putting aside the issue of forced selling, an improvement in earnings visibility will be an important step in encouraging a more positive stance on risk assets. That in turn will require evidence that monetary policy is being allowed to feed through to the real economy as the money and credit markets begin to thaw.

Forecast Summary

I. Forecast summary - Schroders

Real GDP

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	31.4	1.3	-1.5	0.0	0.8	na
UK	5.7	1.1	-2.0	-0.2	0.5	na
Eurozone	25.3	1.2	-0.5	0.5	0.8	na
Japan	10.4	0.7	0.0	0.5	1.3	na
OECD	74.6	1.2	-0.9	0.3	0.9	na
China	6.3	9.8	8.0	8.8	9.0	na
Emerging*	25.4	6.3	4.2	5.6	5.0	na
World	100.0	2.5	0.4	1.6	1.9	na

Inflation CPI

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	31.4	4.4	1.5	2.3	2.0	na
UK	5.7	3.7	2.0	2.9	2.0	na
Eurozone	25.3	3.4	2.0	2.2	2.0	na
Japan	10.4	1.7	0.8	1.1	0.5	na
OECD	74.6	3.7	1.6	2.2	1.8	na
China	6.3	6.4	3.0	3.6	3.0	na
Emerging*	25.4	7.9	3.9	5.8	4.1	na
World	100.0	4.7	2.2	3.1	2.4	na

* **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-08	Dec-09	Market	Dec-10	Market
US	31.4	1.00	0.50	3.53	1.00	2.47
UK	5.7	4.00	2.75	4.67	3.00	3.66
Eurozone	25.3	3.25	2.50	4.08	3.00	3.37
Japan	10.4	0.25	0.25	1.14	0.50	0.80
OECD	72.8	1.91	1.33	3.47	1.78	2.64

Market from forward futures strip as at

23/10/2008

Key variables

FX	Current	Dec-08	Dec-09	y/y%	Dec-10	y/y%
USD/ GBP	1.59	1.50	1.70	13.3	1.70	0.0
USD/ EUR	1.27	1.20	1.45	20.8	1.45	0.0
JPY/ USD	94.3	88.0	100.0	13.6	100.0	0.0
GBP/ EUR	0.81	0.80	0.85	6.6	0.85	0.0
Brent crude	65.1	69.0	71.8	4.0	78.4	9.1
US output gap %GDP	-3.9	-2.8	-4.7		-5.5	
Unemploy. %	6.7	6.4	7.3		8.0	

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

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

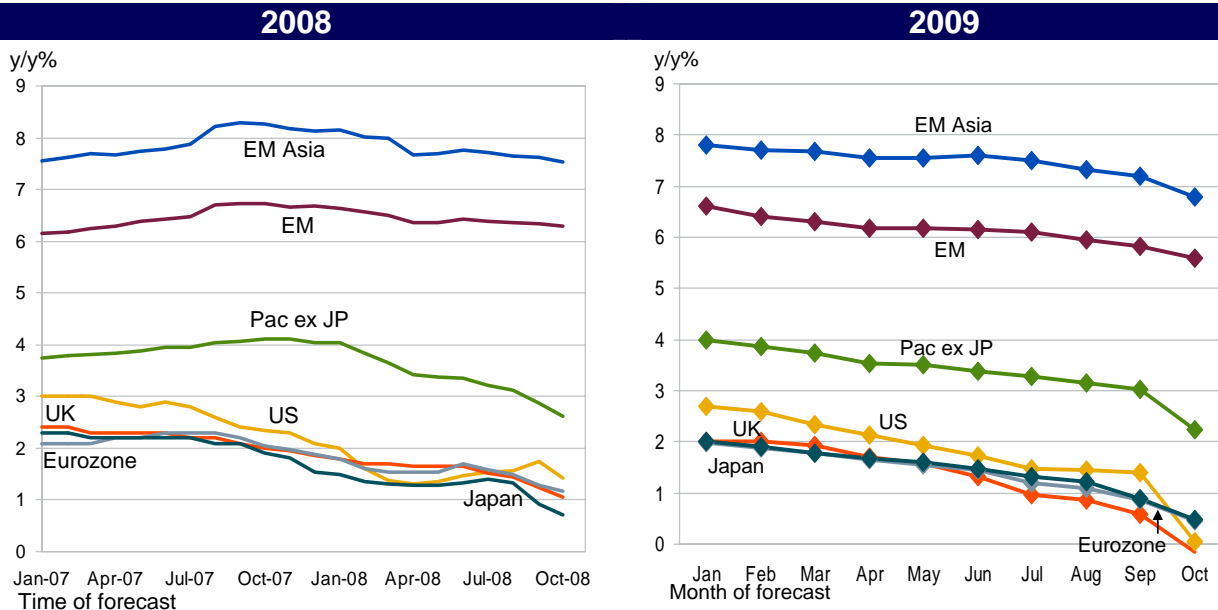
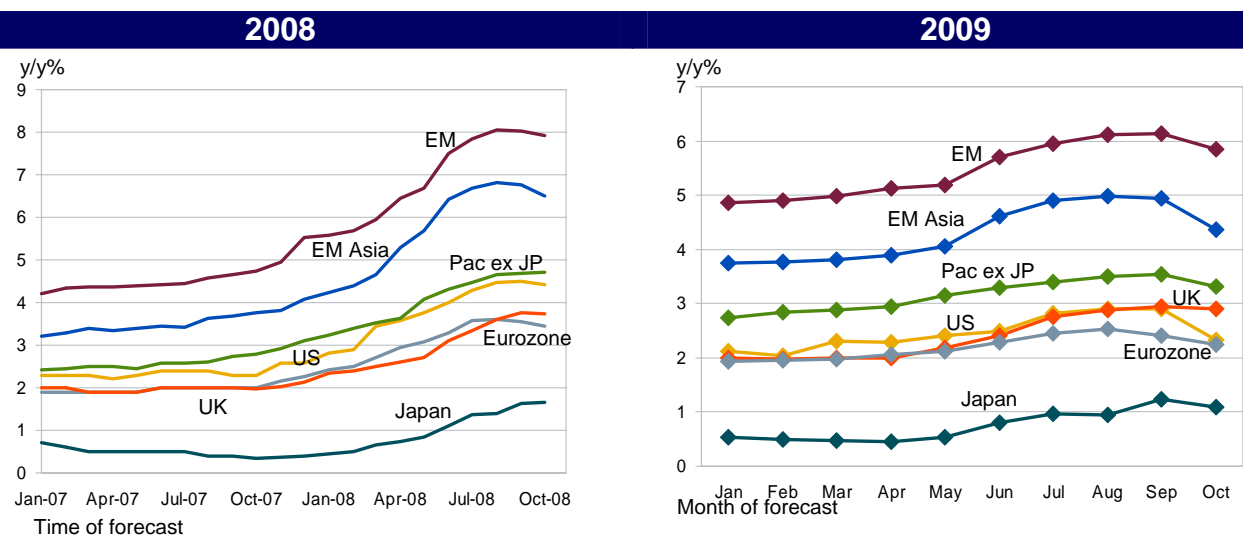


Chart 2: Inflation consensus forecasts



Source: Consensus Economics (Oct.), 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

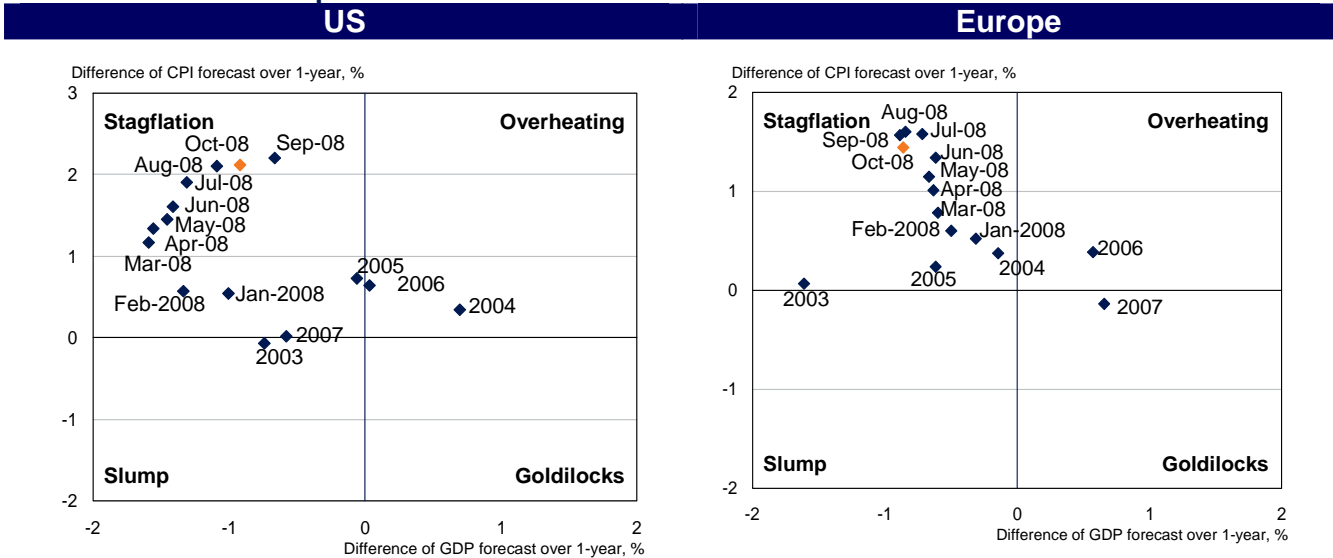
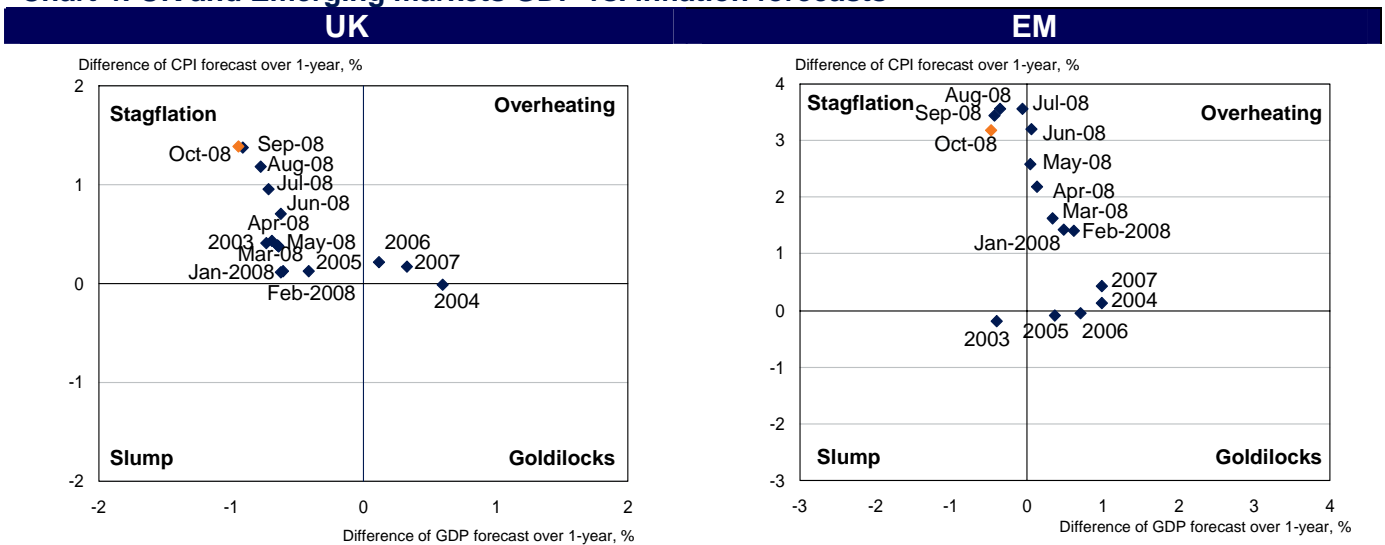


Chart 4: UK and Emerging markets GDP vs. inflation forecasts



Source: Consensus Economics (Oct.), 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.

The views and forecasts contained herein are those of Schroders Investment Management's Economics Team, and do not necessarily represent Schroders Investment Management's house view.

This document does not constitute an offer to sell or any solicitation of any offer to buy securities or any other instrument described in this document. The information and opinions contained in this document have been obtained from sources we consider to be reliable. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that Schroders has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. For your security, communications may be taped or monitored.