Schroders
Economics and Strategy Viewpoint

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The return of deflation? (page 2)

- **After an absence of five years the d-word has returned. The prospect of a global recession combined with falls in commodity prices threatens to push the world economy into deflation next year.**

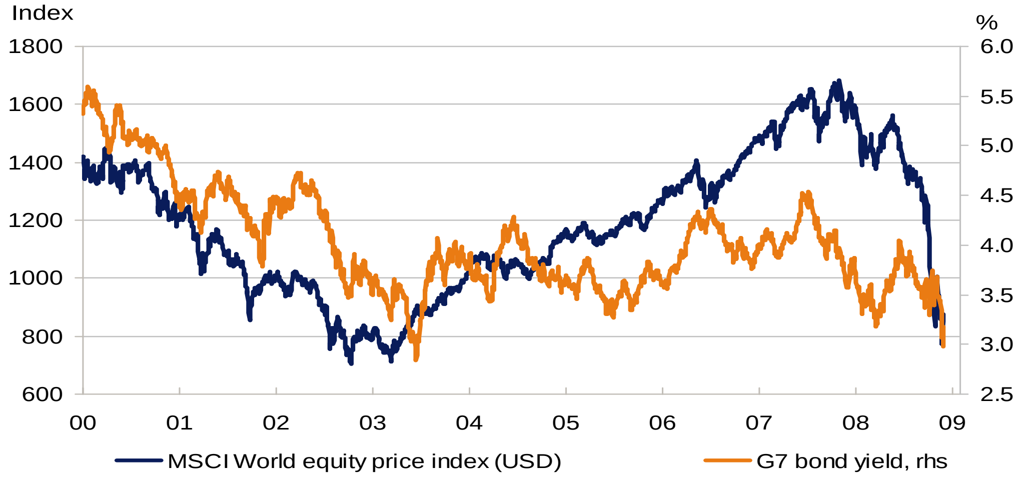
- **We would distinguish between deflation caused by falling commodity prices and a more general decline in the price level. The former is a benefit to consumers and commodity importing economies in general – i.e. the OECD and most of Asia. The latter, however, is the type of deflation experienced during the 1930s and by Japan in the 1990s.**

- **Next year most of the deflation will be of the favourable sort a consequence of the decline in oil and commodity prices. However, core inflation is also set on a downward path and is expected to fall to 1% by the end of 2010. Given the likely depth and duration of the downturn, the risks to this forecast are on the downside. Such an outlook reinforces our view that policy rates will be lower for longer than the markets expect.**

- **Looking beyond the next two years, we do not see deflation as being the dominant theme. Pressures from the emerging markets and the build up of government debt point to inflation risks in the future. The outlook could be a replay of the 1960s when a low rate of inflation in the early part of the decade was followed by a sharp acceleration in prices as fiscal expansion and growth pressures led to overheating.**

Forecast summary (page 5)

Back to 2003 for equity markets and government bond yields



Source: Schroders, Thomson DataStream

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Global

The return of deflation?

Markets have taken a deflationary turn this month with equities losing some 10% in value whilst government bonds have rallied strongly (see chart on front page). Oil prices have also fallen further.

Equity Markets and Government bond yields return to 2003 levels

Such developments are reflected in the economic news flow which has remained poor with the US reporting a sharp rise in jobless claims and officials in China describing the employment outlook as “grim”. Prior to this we saw sharp falls in Purchasing Managers surveys indicating that global growth has tipped over the cliff into recession.

There was better news in the form of the inflation figures which showed that we had passed the peak in headline CPI in the US, Euro zone and UK. We had expected such a development to be favourably received by risk assets. However, markets chose to focus on the deflationary side of the story and fears that the US would go through the same experience as Japan in the 1990s.

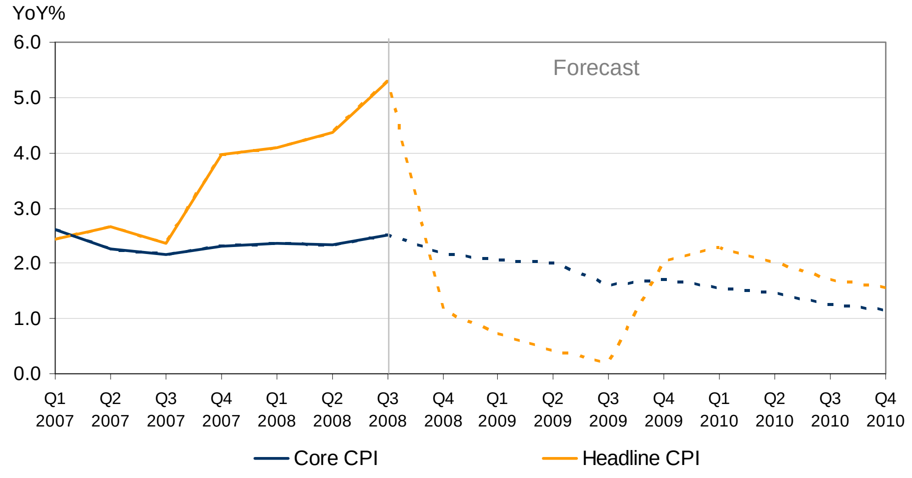
Certainly, the tone of central banks became more urgent during the month. The Fed took measures to buy Mortgage backed and asset backed securities directly and is widely expected to cut rates again when it meets on December 16th. The ECB cut the repo rate by 50 basis points (bps) and the Bank of England surprised markets with a 150 basis point move. The minutes of the monetary policy committee revealed that they had discussed moving by more. Deflation is a danger to monetary policy as it means that central banks lose control of real interest rates, being unable to reduce nominal rates below zero.

At this stage we would not rule out the possibility of deflation, but would distinguish between that driven by lower commodity prices versus a general fall in core prices. The former is a benefit to commodity importing economies representing an improvement in the terms of trade and a gain in income. The latter is more worrying as it may reflect weak demand and so means a squeeze on profit margins resulting in lay offs. The deflation experienced in the 1930s and by Japan in the 1990s was of this type.

When prices are falling companies find it very difficult to cut nominal wages and so seek productivity gains by cutting their workforce. The rise in unemployment then hits consumption weakening the economy further and resulting in more layoffs. The key is for policy to support demand and prevent the economy falling into a contractionary spiral. This was the insight of Keynes who recognised that fiscal policy would be more effective in this environment as monetary policy loses its potency.

Our forecast is for a steep drop in US inflation from its current level to less than 1% in 2009 driven largely by oil prices. We expect the core rate of inflation to drift downward over the next two years as unemployment rises and the output gap opens up. This would take core inflation back to the levels last seen in 2003, the period of the last deflation scare (see chart 1).

Chart 1:US headline and core CPI: recent history and forecast

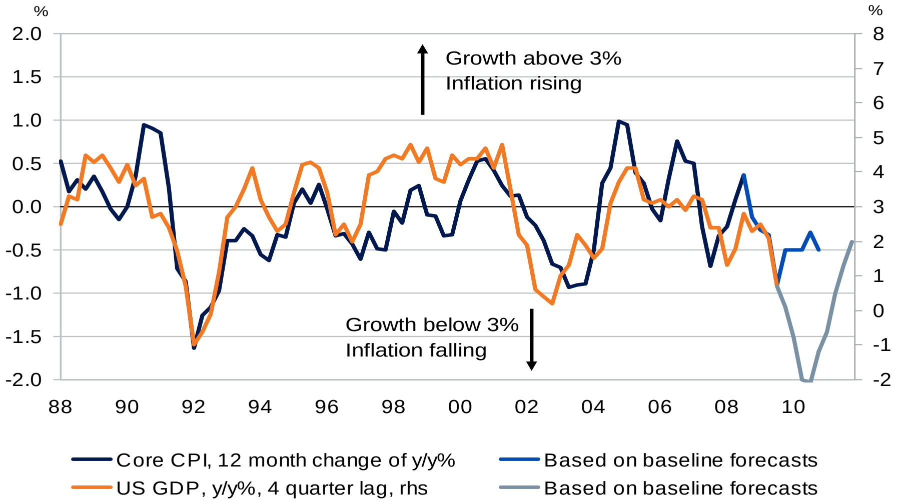


Source: Thomson DataStream, Schroders

Near term inflation risks are on the downside…

It is possible that inflation will fall further in 2011, as even though the economy should be recovering at that point there is still likely to be an output gap. Indeed, the risks are that we see a sharper fall in core inflation than five years ago as the downturn is expected to be deeper with the economy taking longer to return to trend growth (see chart 2).

Chart 2: Growth and inflation trade-off in the US



Source: Thomson DataStream, Schroders

…But longer term risks are skewed upwards

Such an outlook underpins our conviction that the Fed funds policy rate will remain low - i.e. 2% or less - for the next three years. Central banks will be wary of tightening too early and risking a fall into deflation.

However, we do not see deflation as the dominant long run theme. We recently discussed the inflation outlook in some detail in "Inflation: dead not buried"[1]. Highlighting the near term risks discussed above we noted that the pressures from emerging markets and the tensions created by the build up of government debt mean inflation is likely to pick up again. We concluded

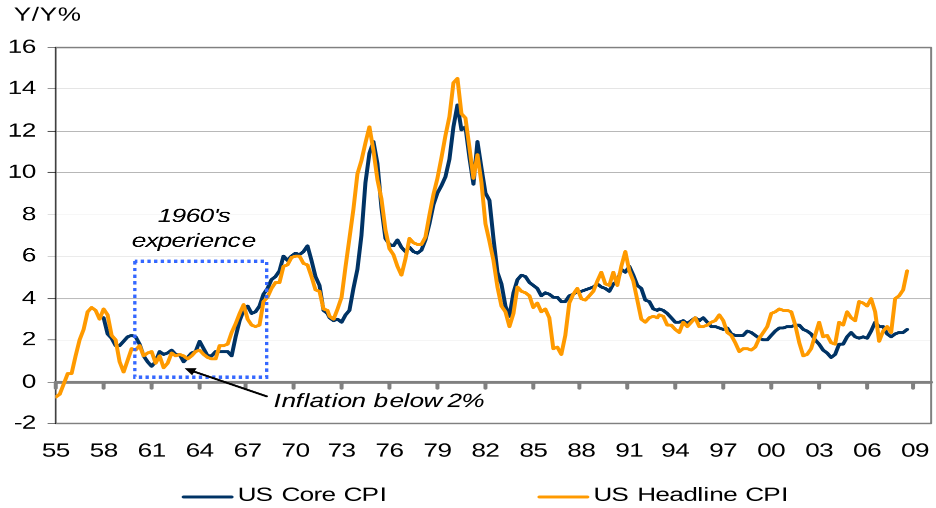
[1] See http://talkingpoint.brighttalk.com/files/2008_nov_Talking%20Point%20template.pdf

"Investors may relax about the outlook for inflation over the next year or so, but should be aware that thereafter the risks become increasingly skewed to the upside".

A return to the 1960's?

In terms of an historical comparison the next few years could look like the 1960s. During the early part of that period, core and headline ran at around 1% before taking off towards the end of the decade (see chart 3). It was excessive fiscal expansion: the combination of spending on the Great Society program and the Vietnam war which overheated the economy and led to the loss of control over inflation.

Chart 3: Headline and core inflation 1955-2008



Source: Thomson DataStream, Schroders

Our caution on the longer-term outlook for inflation is based partly on this experience. Governments find it difficult to withdraw spending stimulus especially when it is associated with high priority political objectives. As private sector activity recovers the continuation of fiscal expansion results in overheating and inflation.

In the current context, increased government borrowing is not a threat to inflation given the weakness in private sector demand. Likewise, the increase in issuance is not a threat to government bond yields as investors find there is little competition for their capital. The problem comes later when both the private and public sectors are strengthening, resulting in increased demand for resources and higher prices. We also note the incentive for a heavily indebted government to "tolerate" a bit of inflation compared to its more prudent counterpart. In my view, this is an issue for two to three years time and not 2009 when the debate is likely to focus on deflation.

Forecast Summary

I. Forecast summary - Schroders

Real GDP

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	31.4	**1.3**	**-1.5**	-0.6	**0.8**	2.0
UK	5.7	**0.9**	**-2.0**	-0.9	**0.5**	2.2
Eurozone	25.3	**1.2**	**-0.7**	-0.2	**0.8**	1.3
Japan	10.4	**0.6**	**-0.6**	-0.1	**0.8**	1.3
OECD	74.6	**1.2**	**-1.1**	**-0.3**	**0.8**	1.7
China	6.3	**9.8**	**7.0**	9.5	**6.5**	9.8
Emerging*	25.4	**6.3**	**3.5**	4.7	**3.0**	6.2
World	100.0	**2.5**	**0.1**	**0.9**	**1.4**	2.9

Inflation CPI

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	31.4	**4.4**	**0.9**	1.4	**1.9**	1.7
UK	5.7	**3.7**	**2.0**	2.5	**1.5**	2.0
Eurozone	25.3	**3.4**	**2.0**	1.8	**2.0**	1.8
Japan	10.4	**1.7**	**-0.2**	0.6	**0.4**	1.2
OECD	74.6	**3.7**	**1.2**	**1.6**	**1.7**	1.7
China	6.3	**6.4**	**3.0**	6.3	**3.0**	3.9
Emerging*	25.4	**7.9**	**3.4**	5.5	**4.0**	5.3
World	100.0	**4.7**	**1.7**	**2.6**	**2.3**	2.6

* **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, Bulgaria, Croatia, Estonia, Latvia, Lithuania

Interest rates

%	Wt (%)	Dec-08	Dec-09	Market	Dec-10	Market
US	31.4	1.00	0.25	2.64	**1.00**	3.69
UK	5.7	2.00	1.50	3.49	2.50	4.46
Eurozone	25.3	2.75	2.00	3.33	2.50	4.01
Japan	10.4	0.10	0.10	0.79	0.50	1.16
OECD	72.8	**1.56**	**0.93**	2.68	**1.57**	3.50

Market from forward futures strip as at 24/10/2008

Key variables

FX	*Current*	Dec-08	Dec-09	y/y%	Dec-10	y/y%
USD/ GBP	*1.55*	1.50	1.45	-3.3	1.50	3.4
USD/ EUR	*1.30*	1.20	1.30	8.3	1.40	7.7
JPY/ USD	*95.3*	88.0	85.0	-3.4	85.0	0.0
GBP/ EUR	*0.85*	0.80	0.90	12.1	0.93	4.1
Brent crude	*50.5*	52.0	64.2	23.4	72.6	13.2
US output gap %GDP	*-4.2*	-3.2	-5.0		-5.8	
Unemploy. %	*6.5*	6.6	7.5		8.2	

Source: Schroders, Datastream, IMF, Consensus Economics (November)

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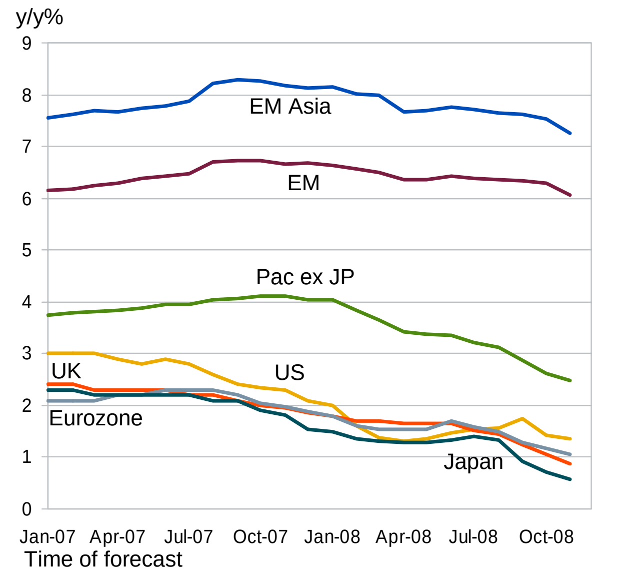
II. Updated forecast charts - Consensus Economics

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

2008	2009



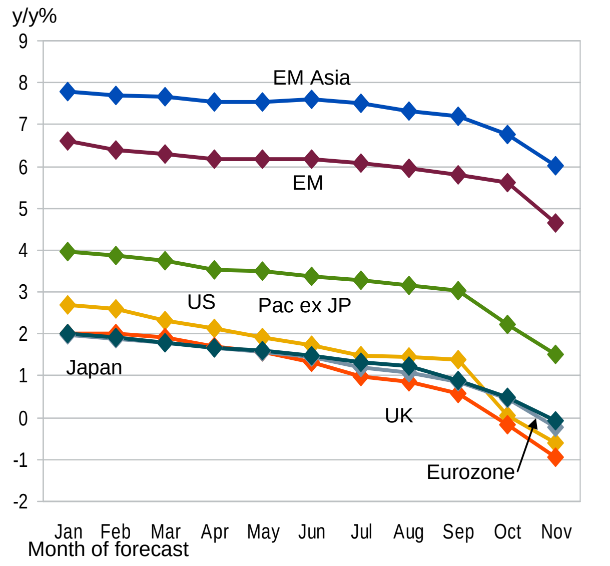
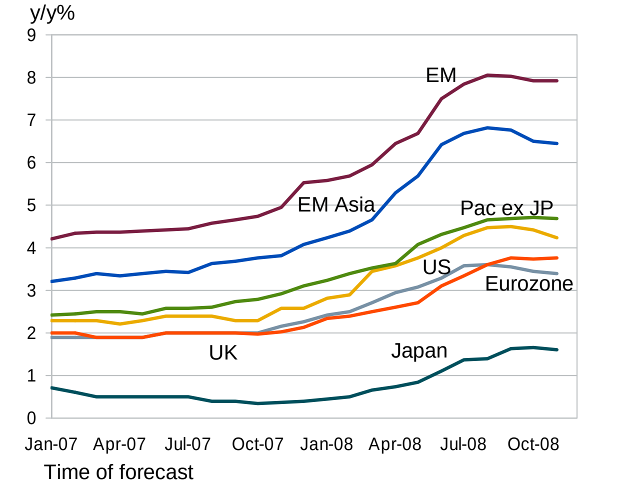
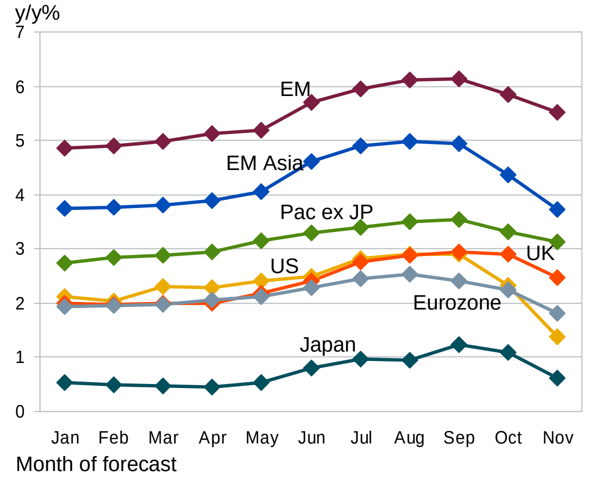


Chart 2: Inflation consensus forecasts

2008	2009





Source: Consensus Economics (Nov.), 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

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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

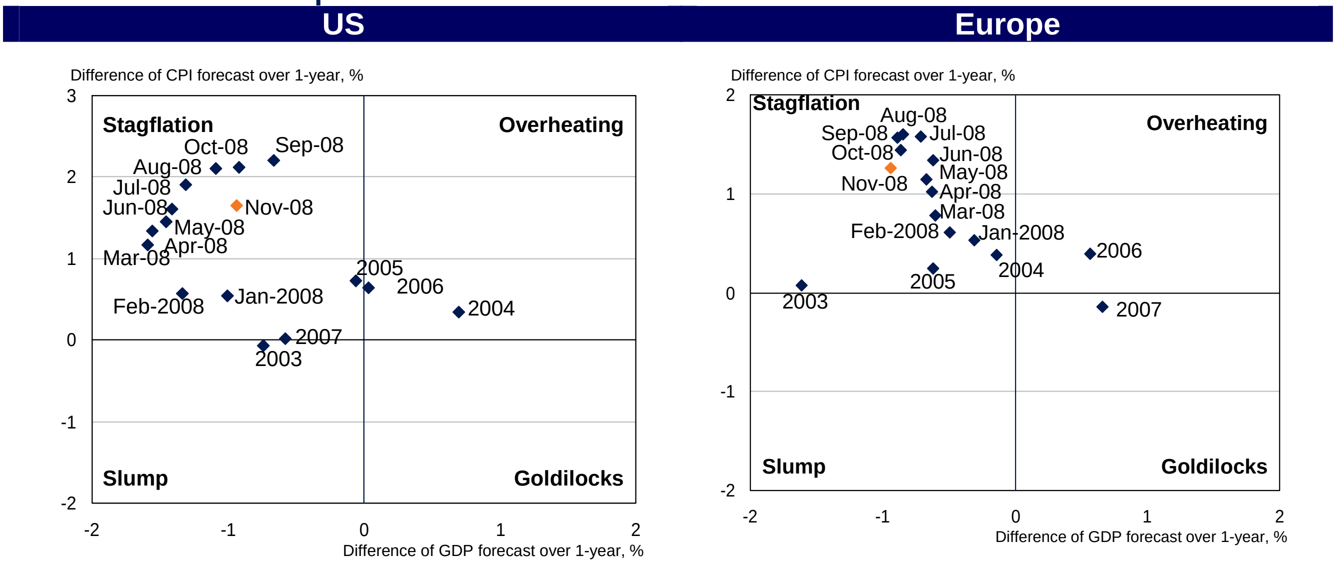
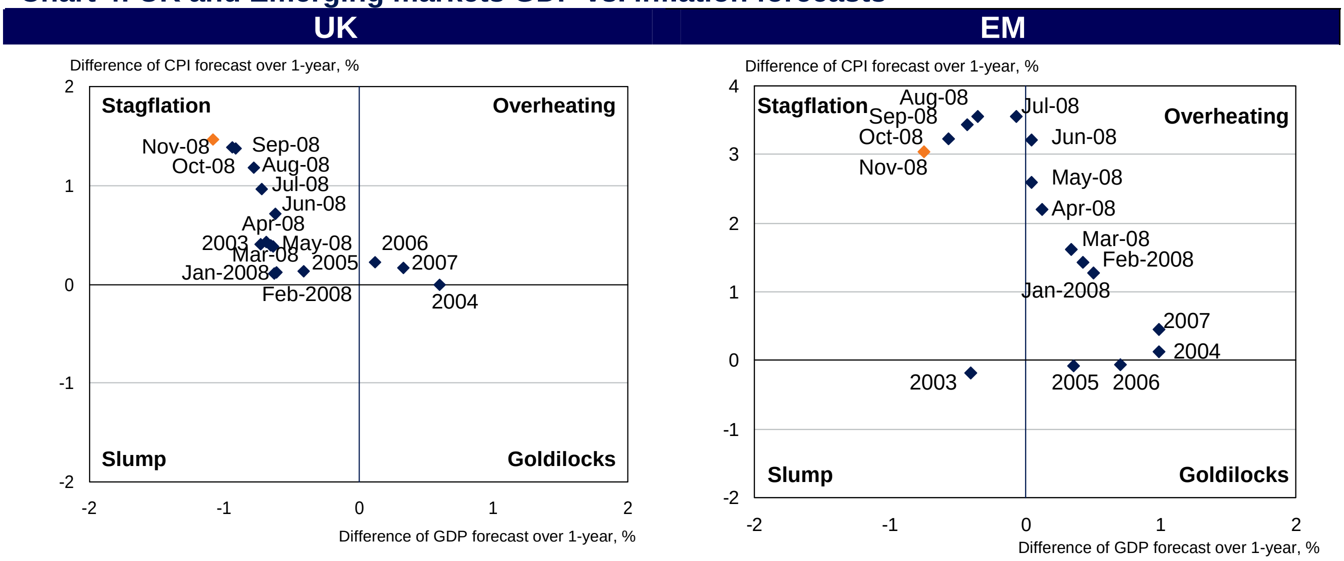


Chart 4: UK and Emerging markets GDP vs. inflation forecasts



Source: Consensus Economics (Nov.), 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.

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