

Schroders

Economics and Strategy Viewpoint

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Gloom and doom as we head into 2009

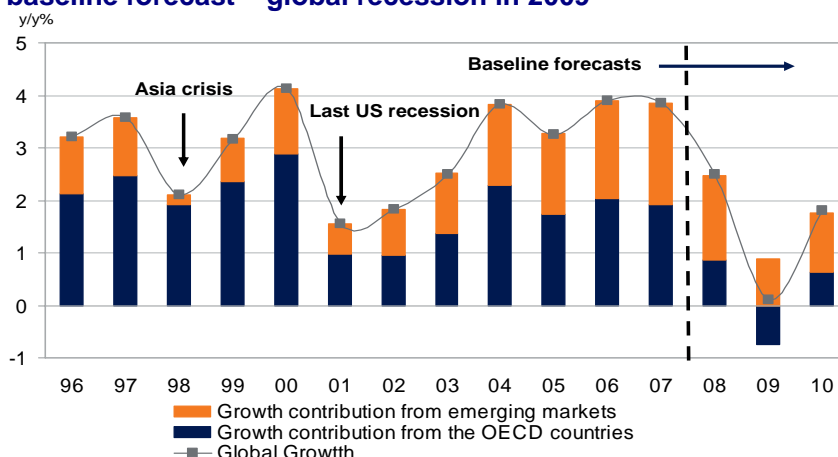
- Global activity is falling with the latest surveys pointing to a sharp contraction in activity. We expect OECD output to contract by 1% next year – the worst performance for more than fifty years. Overall, global growth should be positive, courtesy of a contribution from the emerging markets.
- Nonetheless, despite the gloom we are expecting a modest recovery in 2010 as monetary and fiscal policy begin to improve demand. Lower commodity prices also help by pushing down inflation and boosting real incomes. While much of this is likely to be saved, some will feed through into spending.
- The risk is that the credit crunch continues to overwhelm the efforts of policy makers and prolong the recession. Meanwhile, a number of companies are moving to lock in cash now for fear that banks will not be willing to see them through the difficulties which lie ahead. Such a move highlights the role of pension funds, insurance companies and sovereign wealth funds in funding the economy at a time when the banks are in retreat.

Some investment themes for 2009

- Whilst the economic picture is likely to deteriorate in 2009, the markets need not follow. Sentiment is already extremely depressed with the US market discounting a fall in earnings of 25 to 30% on our estimates. Consequently, there is scope for some positive surprises on activity, probably linked to the announcement of President Obama's fiscal package. Low interest rates will also force investors to move out along the risk curve in pursuit of yield.
- On a less positive note, the economic crisis will expose structural flaws in the world economy. In this respect, some currencies could be vulnerable: either due to the tensions created by the need to raise overseas finance (in the case of the GBP) or the problems of divergent economic performance within a currency bloc (e.g. the Euro).

Forecast summary (page 7)

Our baseline forecast – global recession in 2009



Source: IMF, Consensus Economics, Schroders, December 2008



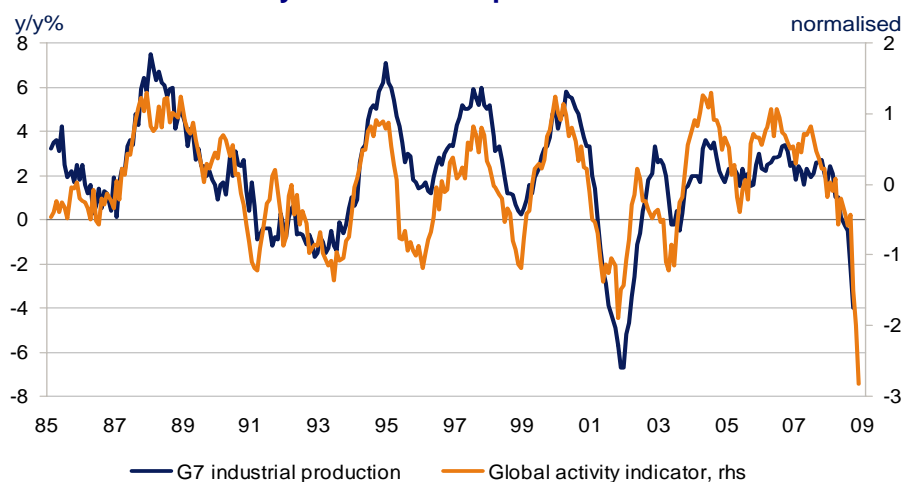
Global

Gloom and doom as we head into 2009

World economy ends year in free fall

The outlook for the world economy remains poor with the downturn in the consumer sector now spreading to industry. Our activity indicator is now at its lowest level since 1985 as companies respond to the squeeze from weaker demand and tighter credit by cutting output and employment. The final quarter of the year is likely to see some of the sharpest falls in GDP since the global recession of 1980.

Chart 1: Global activity indicator collapses



Source: Thomson Datastream, Schroders. Note: Global activity indicator is a composite of the US ISM manufacturing survey, the Japan Shoko Chukin small & medium firm survey and Belgium business indicator survey.

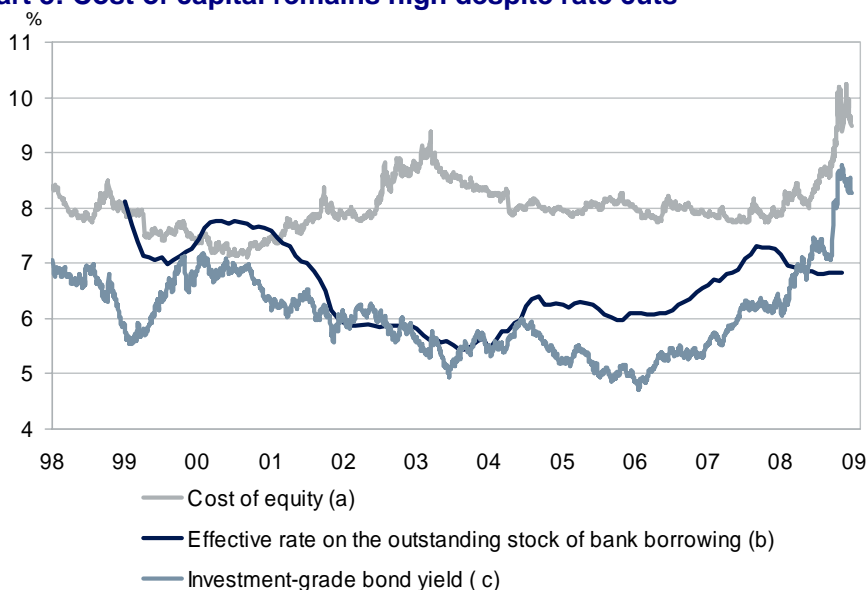
Such an outlook has led some to despair over the prospects for growth in the world economy and certainly a global recession in 2009 is likely. Our central forecast predicts a contraction in OECD GDP of 1% next year, the worst performance since the second world war. After adding in the contribution from the emerging market economies, global activity is predicted to record a negligible rise. However, we do see a recovery in 2010, albeit a weak one, but a recovery nonetheless (see chart on front page).

Recovery based on the view that policy action can overcome the headwind from the credit crunch

Underlying this is our view that the action by the authorities in easing monetary and fiscal policy will be sufficient to overcome the head wind created by the credit crunch. This is the great uncertainty facing the world economy today and the issue, which divides optimists and pessimists.

All the evidence so far has shown that policy has not worked, largely as a result of banks not passing on central bank rate cuts to their customers. Conventional monetary policy in this respect has become impotent. The cost of capital has remained high due to an increase in risk premiums on all forms of lending.

Chart 3: Cost of capital remains high despite rate cuts



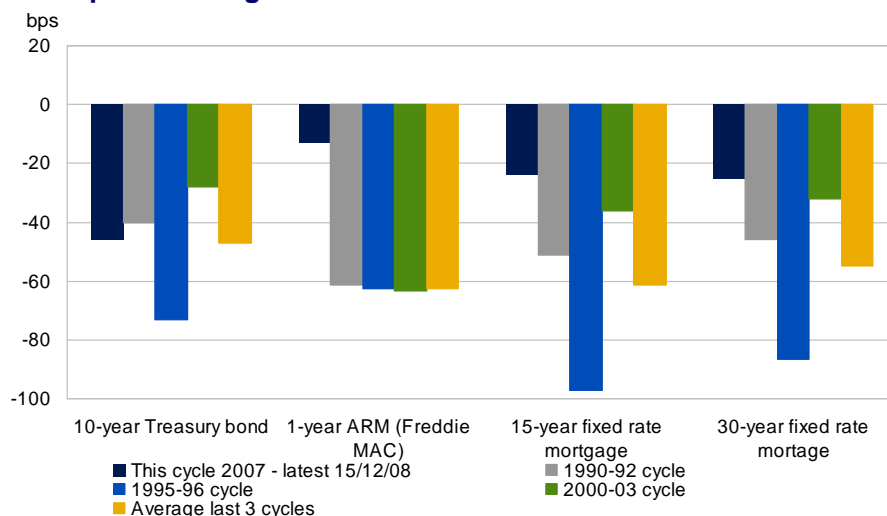
Source: Bank of England, Bloomberg

- (a) Estimated using equity prices of UK non-financial companies and by assuming nominal dividend grow at 5% annum.
- (b) Average rate paid by existing borrowers on overdrafts and other loans, calculated using data on interest rate flows and outstanding stock of borrowing. Latest data are for September 2008.
- (c) Merrill Lynch Sterling corporate & collateralised index

In the UK, the response has been to call the chief executives of the major banks into 10 Downing Street for a “discussion” on their lending practices with the Prime Minister. Full nationalisation of the banks cannot be ruled out.

In the US, the Federal Reserve and the Treasury have started to address the problem through market means such as announcing the potential purchase of Treasuries, Mortgage backed and other asset backed securities. Such announcements have had a dramatic impact on the long end of the Treasury curve and are also bringing down mortgage rates.

Chart 4: Policy progress: response of bond yield and mortgage rates to 100bp Fed easing



Source: Thomson Datastream, Schroders



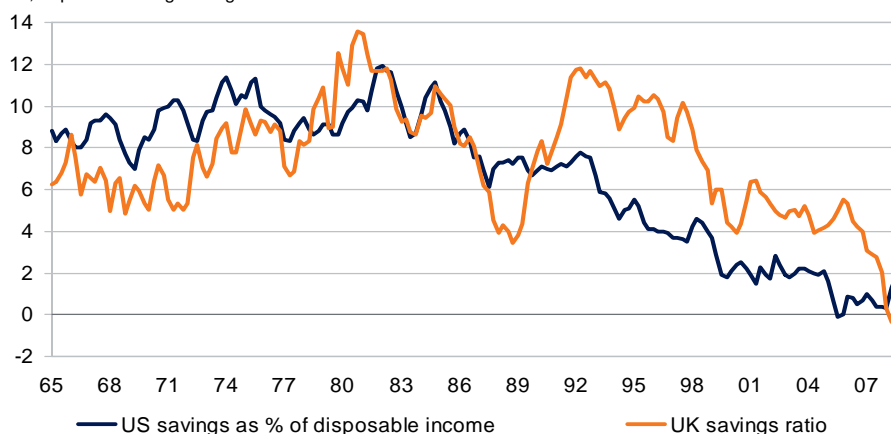
House prices are likely to continue to fall in both the US and UK, but lower mortgage rates should bring benefit to many existing borrowers who can profitably refinance at current rates and mortgage applications are surging in the US.

Lower inflation will help boost consumer spending power

This will provide a boost to household cash flows as will the fall in commodity prices and inflation. One contributory factor to the weakness of activity in 2008 was the rise in inflation and squeeze on real incomes. This will reverse in 2009, so giving those households who stay in work gains in real incomes. On top of this, tax cuts should provide additional income and the question then is whether the improvement in income will be used to spend or pay down debt. One likely consequence of the credit crunch is that the long decline in the savings rate in the US and UK is now over and that savings will probably rise. As a result, we expect a significant portion of the improvement in income to be saved in 2009. Although it maybe healthy in the long run, the risk is that the rise in saving outweighs any tax cut thus resulting in little effect on activity.

Chart 5: Savings rate in the US and UK

%, 2 quarter moving average



Source: Thomson Datastream, Schroders

Note: Response of bond yield and mortgage rates to 100bps Fed easing.

Companies are seeking to by-pass the banks and lock in cash now

Meanwhile, the corporate sector is responding to the squeeze on funding by cutting capital expenditure as well as employment. The credit crunch is putting a premium on cash as firms fear that bank credit will not be forthcoming as the downturn deepens.

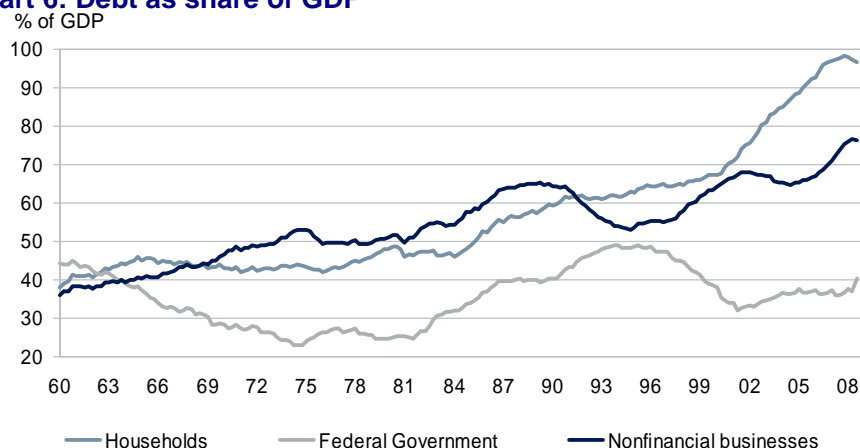
One response to this has been a wave of new issuance. Figures from Dealogic show that European non-financial companies have sold more than \$50bn of bonds since November. The US has also seen a sharp increase as companies lock in cash to see them through the downturn. Such a move comes at a price as issuers have to pay to get deals away with US AA-rated yields averaging 290 basis points above interbank lending rates.

We can expect a lot more new issuance in the New Year and while this may be seen as a threat to corporate bond prices, those companies that obtain funding will be far more secure than those who leave it too late to raise capital. Of course, by going directly to the institutions, companies are bypassing the banking sector. Given that pension funds, insurance companies and sovereign wealth funds hold considerable cash at present there is scope for much more disintermediation of the banks.

Rebalancing: public and private debt

One way to look at the current adjustments taking place in the world economy is in terms of the level of debt in different sectors. Using figures for the US we can track the relentless rise in household debt. This has now reached a record 100% of GDP. Against this has been a fall in US federal government debt, which has declined to 40% GDP. Going forward, these trends are expected to reverse with private debt falling as firms and households de-lever, while the government takes the strain through higher budget deficits.

Chart 6: Debt as share of GDP



Source: Thomson Datastream

Potential for a better 2009

Some investment themes for 2009

Following what is likely to be the second worst annual performance by the US and UK equity markets on record, investors will be glad to see the back of 2008.

Looking into 2009, doubts about the recovery are likely to persist as investors question the ability of policy to lift activity. In our view this accounts for why markets have failed to stabilise and rally as they have in the past during this stage of the cycle. In other words, despite historically low valuations, investors do not have the confidence to look through the downturn and re-rate the market due to the lack of visibility on earnings. This should begin to change in 2009 for three reasons.

First, extremely depressed sentiment creates scope for positive surprises. The low rating of the market and the downward adjustment of growth and earnings forecasts should make risk assets more resilient to bad news. We estimate that the US market is already discounting a fall in earnings per share of 25 -30 % over the next two years. Credit markets are discounting something worse.

Second, do not ignore the power of policy. President Obama will announce a fiscal package in January rumoured to amount to more than \$500 billion (3.5% of GDP). Combine this with measures announced elsewhere and the ongoing efforts of central banks to boost growth, and there is scope for an improvement in sentiment.



Third, the trade off between security and yield will move toward the latter. One consequence of central bank action has been to drive down yields on safe assets to generational lows. Such a move has been reinforced by the risk aversion of investors. However, many investors who rely in interest income will find this a difficult environment and consequently will be driven up the risk curve in the search for higher yields.

These are all positive factors, which suggest we should at least get a bear market rally next year. Against this are two potential negatives.

The first is deflation. Whilst we see next year's fall in inflation as being helpful to the economy, the markets may not agree and will fret about whether the major economies are about to turn into Japan of the 1990s¹. This would reinforce the move into secure defensive assets and away from risky cyclical bets. Arguably though, the market is already pricing this in given the level of equities, credit and break-evens on TIPS.

Second, hard economic times expose the structural flaws in the world economy. Two that immediately spring to mind are in the currency arena. The UK economy suffers from a twin deficit problem i.e. a budget and current account shortfall, and so effectively relies on overseas investors to finance a significant part of the budget deficit. Gilt auctions could therefore prove to be difficult periods for the GBP. The failure of an auction would also be a major blow for gilt yields.

Another potential crisis area is the Eurozone with the current tone being taken by the German government reminiscent of that which led to the problems in the old Exchange Rate Mechanism following the reunification of Germany in 1990. Spain and Ireland are vulnerable in an environment where German pressure causes the European Central Bank to put the brakes on policy easing.

On balance, we should see the ECB yielding to lower rates as recent indicators suggest Germany is also experiencing a significant deceleration. Such a move would ease tensions in the Euroarea.

¹ See last month's Viewpoint for a full discussion.

Forecast Summary

I. Forecast summary - Schroders

Real GDP

y/y%	Wt (%)	2008	2009	Consensus Economics forecast	2010	IMF forecasts
US	31.4	1.3	-1.4	-1.3	0.9	2.0
UK	5.7	0.9	-2.0	-1.5	0.5	2.2
Eurozone	25.3	1.2	-0.7	-0.9	0.8	1.3
Japan	10.4	0.6	-0.6	-0.9	0.8	1.3
Australia	1.8	2.5	1.5	1.1	2.0	3.1
OECD	74.6	1.2	-1.0	-1.1	0.8	1.7
China	6.3	9.8	7.0	7.8	8.0	9.8
Emerging*	25.4	6.3	3.5	3.5	4.5	6.2
World	100.0	2.5	0.1	0.1	1.8	2.9

Inflation CPI

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	31.4	4.4	0.9	0.3	1.9	1.7
UK	5.7	3.7	2.0	1.2	1.5	2.0
Eurozone	25.3	3.4	2.0	1.4	2.0	1.8
Japan	10.4	1.7	-0.2	0.1	0.4	1.2
Australia	1.8	4.5	0.0	2.8	2.2	3.0
OECD	74.6	3.7	1.2	0.8	1.7	1.7
China	6.3	6.4	3.0	1.7	4.0	3.9
Emerging*	25.4	7.9	3.4	5.2	4.0	5.3
World	100.0	4.7	1.7	1.9	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	0.25	0.25	1.48	1.00	2.06
UK	5.7	2.00	1.00	2.41	2.00	3.46
Eurozone	25.3	2.50	1.00	2.44	1.50	3.06
Japan	10.4	0.10	0.10	0.47	0.50	0.63
OECD	72.8	1.15	0.55	1.74	1.18	2.31

Market from forward futures strip as at 19/12/2008

Key variables

FX	Current	Dec-09	y/y%	Dec-10	y/y%
USD/ GBP	1.49	1.45	-2.8	1.45	0.0
USD/ EUR	1.39	1.35	-3.1	1.40	3.7
JPY/ USD	89.4	90.0	0.7	100.0	11.1
GBP/ EUR	0.93	0.93	0.3	0.97	3.7
Brent crude	40.7	64.2	57.6	72.6	13.2
US output gap %GDP	-2.1	-5.1		-5.8	
Unemploy. %	6.0	7.5		8.2	

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

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

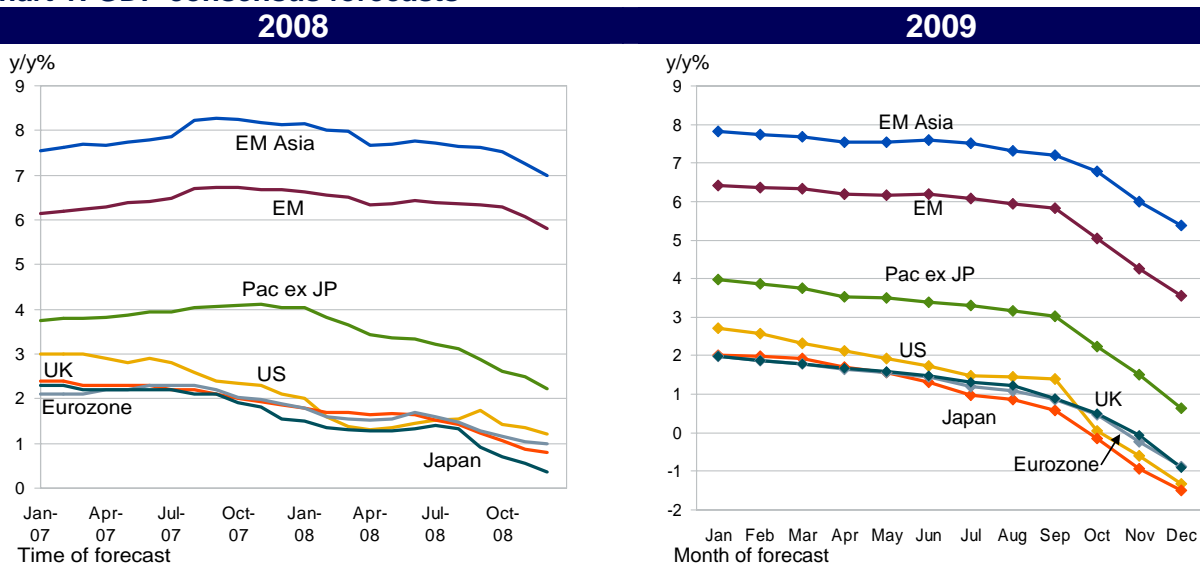
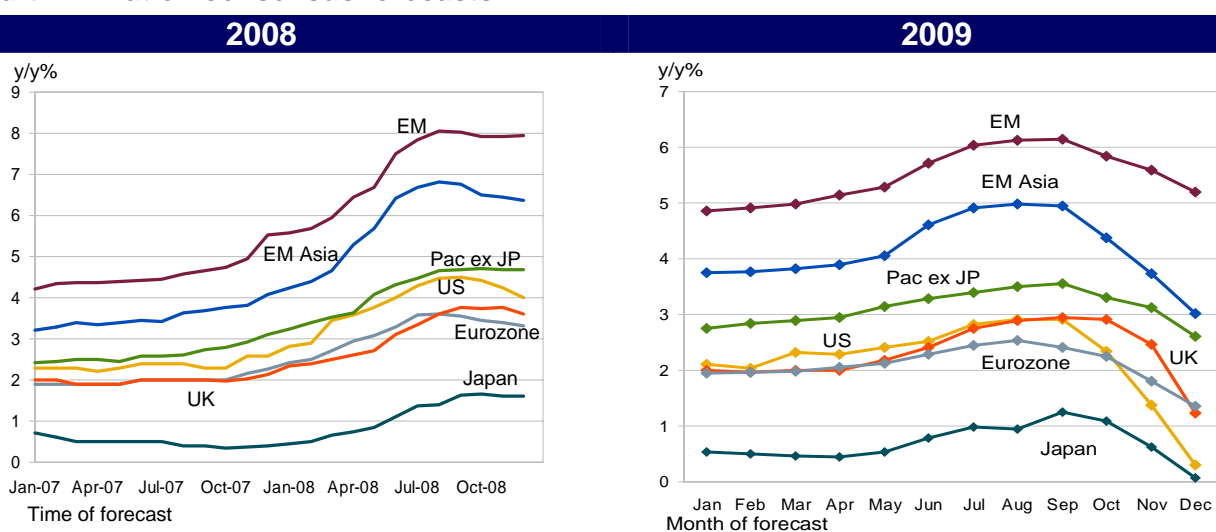


Chart 2: Inflation consensus forecasts



Source: Consensus Economics (Dec.), 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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