

Schroders

Economics and Strategy Viewpoint

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Into the valley

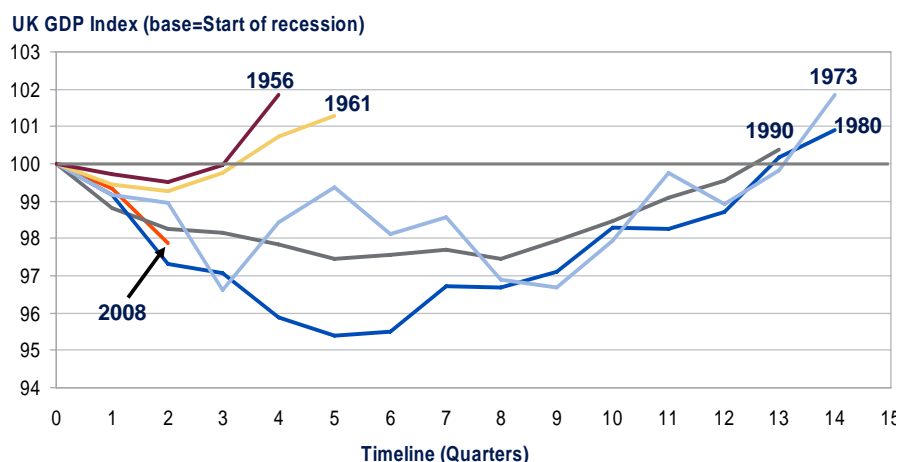
- There has been little respite from the global downturn this month with business surveys and output falling around the world. Export growth has tumbled and China has experienced its weakest quarter of growth for seven years. The UK has been no exception and entered its first recession since 1990 in the second half of last year.
- By the standards of the past, the recession has only just started and all the evidence suggests that this downturn will be no different, and perhaps even worse than the last three major downturns. Analysis of past banking crises suggests that the impact on the economy tends to be greater than a normal recession in terms of loss of output and duration. Crises in the banking sector blunt the effectiveness of monetary policy.
- The current downturn is unique as the main driver of global growth, the US, is affected. This makes it harder for an economy to achieve the export led growth needed to compensate for the weakness of domestic demand in the wake of the credit crunch. Hopes that China will pick up the slack may be disappointed in a world where that economy has been, and remains, a major producing nation rather than a consumer.

Options for the UK

- Our estimates suggest that there are still losses on bank balance sheets, which could run to \$800 billion. UK banks will account for a significant part of this. We are sceptical that the British government's Asset Protection Scheme will be the silver bullet needed to unclog bank balance sheets. Consequently, there is still a high probability of nationalisation. Sterling is likely to remain vulnerable in this environment.

Forecast summary (page 9)

UK recessions, 1956 – 2008: current downturn is worse since 1980



Source: Thomson Datastream, Schroders as of 27/01/09

Recession is defined as 2 or more consecutive quarters of negative real GDP. Dates refer to year in which recession started.



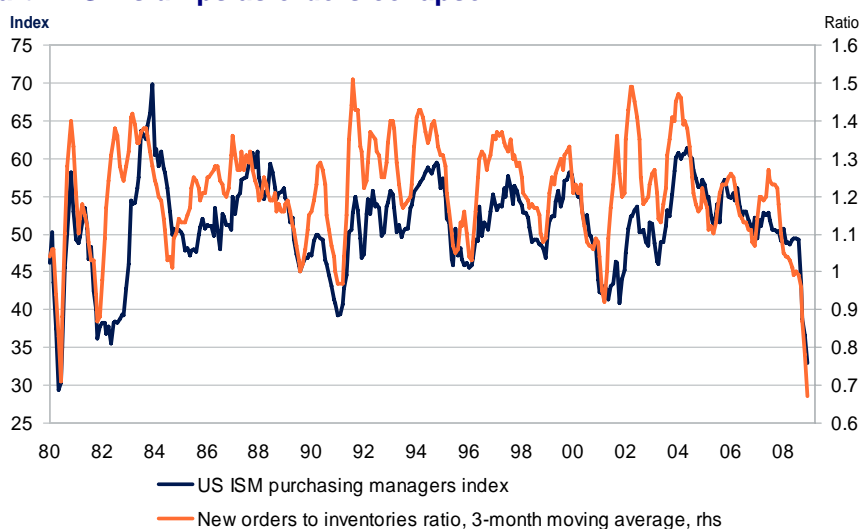
Global

Into the valley

The world economy is experiencing a synchronised downturn in activity

The past month has brought a raft of gloomy news on the world economy with output and employment plunging around the world. The US ISM indicator recorded its weakest reading since 1980 as orders collapsed to their lowest level since the survey began in 1948 (chart 1). Exports have been falling around the world with Asia experiencing some of the sharpest declines. China, the powerhouse of the region, recorded its weakest GDP growth for seven years in the final quarter of last year. Over the next month, we expect all the major economies to record falls in output for the final quarter of the year, confirming that the downturn is truly synchronised.

Chart 1: ISM slumps as orders collapse



Source: Thomson Datastream, Schroders as of 27/01/09

Largest contraction in UK output for 28 years

For the UK, the fourth quarter GDP figures confirmed that the economy had entered its first official recession since 1990. This represented the second consecutive quarter of falling GDP with economic activity declining by 1.5%, the biggest contraction for 28 years. The current downturn is now on a par with the 1980 recession, which proved to be the worst since 1945 (see chart front page).

During that episode, output fell by 4.5% from peak to trough over a period of five quarters. Activity did not regain its previous peak until 1983, some three years later. Although the loss of output was not as great, the recession of 1990 was of similar duration, while the downturn of the 1970s saw the economy experience a double dip before returning to its previous peak after three years.

Early days

Clearly, by the standards of the past the recession is just beginning. All the evidence suggests that this recession will be no different and perhaps worse than the last three major downturns. Each of the previous episodes was characterised by a burst of inflation with the recession being the painful, but necessary means of bringing prices under control. Having achieved this, the authorities were able to generate a recovery by cutting interest rates.



In the current situation, inflation is not a problem aside from the commodity-inspired burst of last summer. Instead, it is the credit crunch and the difficulties policy makers are experiencing in delivering stimulus to a world where the normal credit creation mechanisms have broken down. In this case, the recession is the problem not the solution as the authorities lack the tools to turn the economy around.

Downturns caused by banking crises are long and deep

Breakdown of credit creation mechanisms indicates an extended downturn

In a recent study, economists Reinhart and Rogoff¹ found that the downturn created by a banking crisis tends to be long and deep with GDP per head declining some 9% on average over a period of 2 years. Unemployment increased by 7 percentage points and the public debt rose by 86% in real terms as taxes fell and the government increased spending to boost the economy.

Although all downturns are different and the spread of experience can be wide, the indications are that this banking crisis will bring a long hard slog for not just the UK, but also the world economy. This reflects two factors that are unique to the current situation.

First, it is global. In the past economies have been assisted in their recovery from crisis by strong demand from the rest of the world. In this case, the recession is being felt across the Americas, Europe and Asia. This makes it harder for an individual economy to achieve the export led growth needed to compensate for the weakness of domestic demand in the wake of the credit crunch.

Producers and consumers need to change roles

Second, for the past decade or more the world economy could be divided into producers and consumers. The former being China, Japan and Germany while the latter are the US, UK and other Anglo economies. The producers ran large current account surpluses while the consumers ran deficits. The resulting imbalances were sustained by a massive flow of capital from the producers to the consumers, primarily from China to the US. This prevented the renminbi from rising and funded the US deficit, thus keeping interest rates low and spending strong.

The key point is that today we need to see the producers and consumers changing places. The US and UK need to become strong export producers, while China, Japan and Germany need to increase consumption and imports. The ability of politicians and policy makers to effect this change will be a key determinant of the health of the world economy.

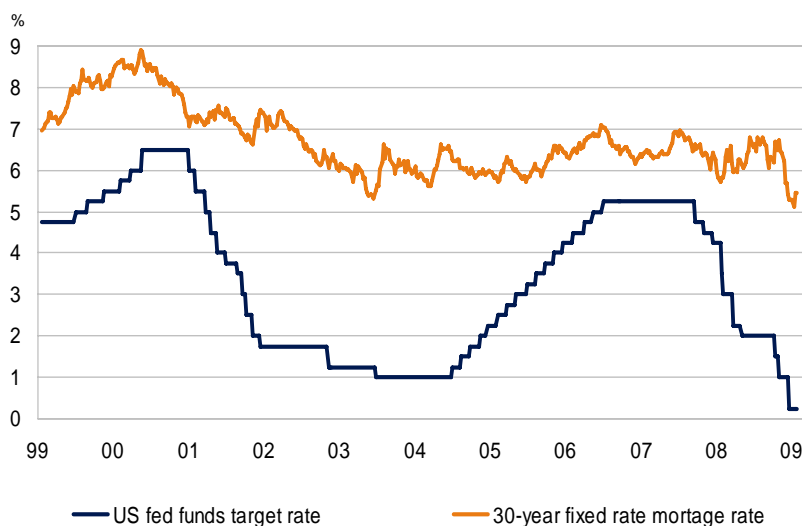
We will return to this issue in the future, but at this point highlight that it may well pose a structural obstacle to global growth as it is not easy for an economy to change roles. New US Treasury secretary Tim Geithner has already raised the temperature of the debate by labelling China a currency manipulator.

¹ Reinhart and Rogoff, The Aftermath of Financial Crises, 2009

Some good news

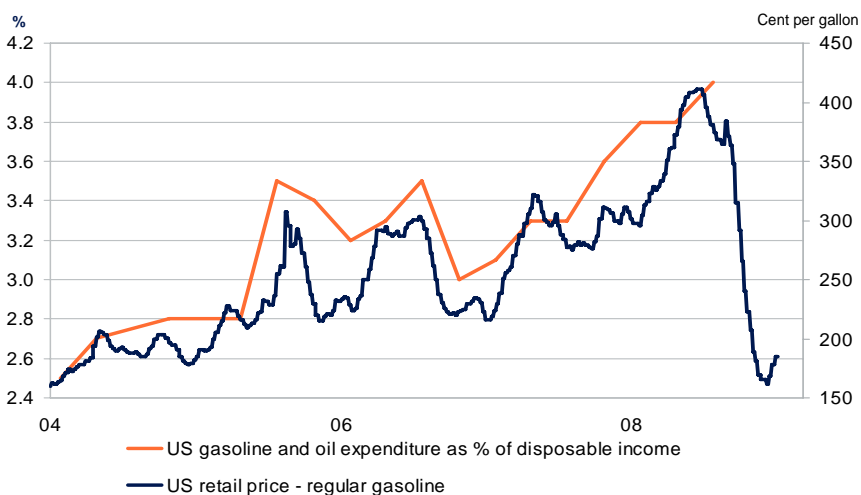
The good news in the near term is that there is some evidence that after the very sharp rate cuts of the past three months and the action by the Fed to buy mortgage backed securities, borrowers are seeing some benefit in terms of lower interest payments (chart 2). In addition to this, the fall in oil prices will act like a tax cut to households and is worth 1.5% of disposable income some \$160 billion to US households (chart 3).

Chart 2: Fed funds and impact on mortgage rates



Source: Thomson Datastream as of 27/01/09

Chart 3: Oil tax in the US



Source: Thomson Datastream, Schroders as of 27/01/09

...and some more bad

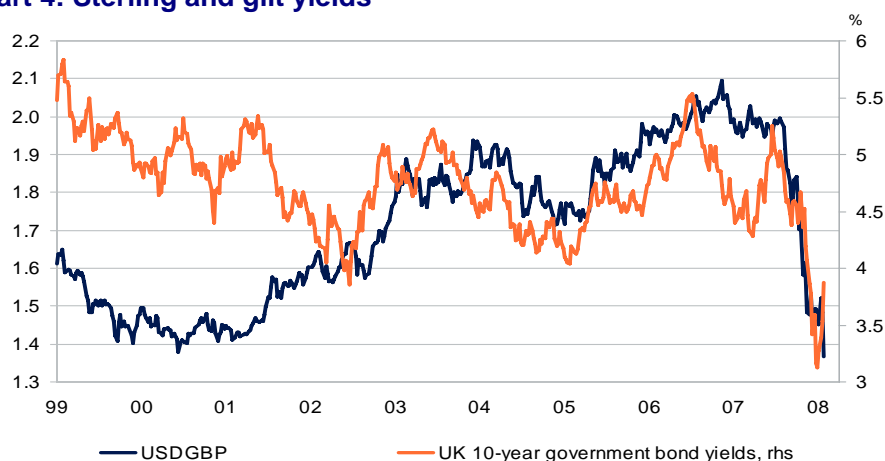
The bad news is that after a brief respite in December and early January the banking crisis is back. The next section looks at this in more detail and gives our view on how events are likely to play out in the UK.

Where are we in the crisis?

The fate of the banks and the pound sterling have become tied together

Last week saw the S&P financials index experience one of its sharpest ever falls as it crashed to a 14-year low. In the UK, the shares of RBS are down some 98% from their peak and, with the British government likely to own 70%, the company is on the brink of nationalisation. The original rescue package launched in October last year has not succeeded in saving the banks, nor more importantly has it provided the kick start to get lending going again. The problems in the banking sector are seen as a major drag on the pound sterling with talk of the government being forced to go to the IMF. This is an outside possibility, but in our view sterling weakness reflects the dramatic move in interest rate expectations as evidenced by the fall in gilt yields (see chart 4).

Chart 4: Sterling and gilt yields



Source: Thomson Datastream as of 27/01/09

The UK government argues that decisions on the allocation of capital are best left to the commercial sector. Whilst such a view might be debatable given some of the commercial decisions made by bankers in the recent past, it is clear that the authorities are desperate to avoid the nationalisation of the banks. Such a position is likely to prove unsustainable in our view.

The scale of capital required and the lack of any private sector appetite for bank equity means there is little alternative to more government intervention. This is likely to take the form of nationalisation of RBS and possibly Lloyds, combined with the creation of a bad bank to take toxic assets off the balance sheets of the remaining banks, primarily Barclays. Such a conclusion follows from our scepticism about the government's plan to insure toxic assets through the new Asset Protection Scheme.

Broken balance sheets

The underlying problem for the banks, not just in the UK but across the US and Europe, remains one of damaged balance sheets with the full cost of the sub-prime debacle yet to be accounted for. Unravelling and valuing credit derivatives is, even at the best of times, difficult. Today the problem is compounded by the global downturn, which is adding the cyclical losses of the recession to the tally of write-offs.

The latest figures from Bloomberg show that banks, brokers and insurance companies in the US, Europe and Asia have written off just over \$1000 billion. This has been matched by capital raised in the banking sector, but for insurers and the GSEs (Government Sponsored Enterprises), losses exceed capital.

Table 1: Financial sector write-downs and capital raised, USD billion.

	Write downs and credit losses	Capital raised
Worldwide	1037.1	925.1
Banks/ brokers	777.8	794.7
Insurance co.'s	144.8	94.0
GSEs	114.4	36.4

Source: Bloomberg as at 26/01/09

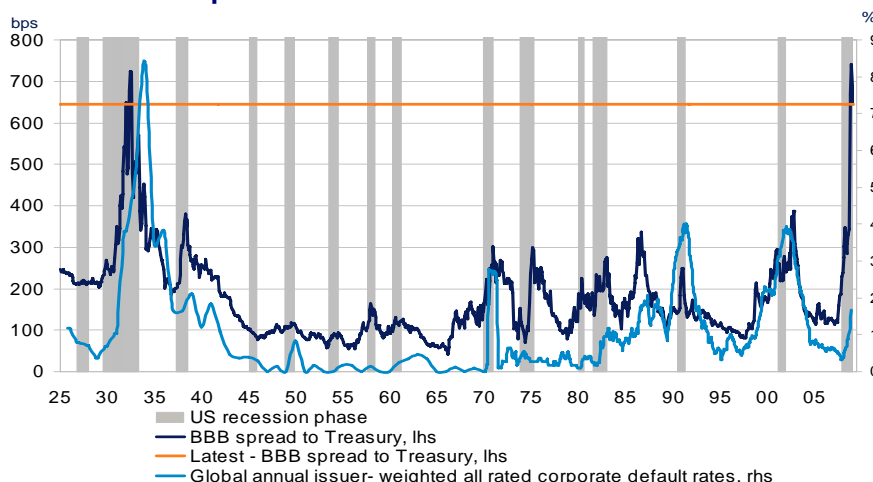
Back in October last year the Bank of England estimated that total write-downs for all investors on Mortgage Backed Securities (MBS), investment grade and high yield bonds would be \$2.8 trillion. On that basis, we are only a third of the way through the total level of write-offs. By adding in potential losses from the increase in defaults it is not difficult to get to higher numbers.

Gap between estimated losses and write-off suggests further government intervention

On the basis of the Bank of England figures, the \$1.8 trillion gap between declared losses and official estimates is a significant reason for the continued doubts about the viability of the banking sector. Part of the gap reflects losses made by individuals, hedge funds and pension funds who are not included in the above table and which may well amount to another \$200 billion. The rest, however, is likely to reflect a reluctance on the part of banks to accept mark to market pricing and instead to use mark to model valuations.

It is possible to argue that market prices are unrealistic and discount a far worse outcome for the economy than is likely. If held to maturity the assets would be worth far more than their current market valuation. There is some backing for this in the Bank of England's own analysis where they calculate that the economic value of many parts of the credit markets is above that being offered by the market. Indeed, our own preference for credit is based on similar reasoning with credit spreads on BBB securities, for example, at levels last seen during the Great Depression.

Chart 5: Credit spreads and default rate



Source: Morgan Stanley, NBER (National Bureau of Economic Research), Moody's Global Corporate Finance, Thomson Datastream as at 27/01/09

Nonetheless, the collapse of the shadow banking system, in the form of hedge funds and off balance sheet Structured Investment Vehicles (SIV's), means that liquidity has disappeared from many areas of the credit universe, making these assets difficult to sell. Although there is a growing appetite amongst insurance companies and pension funds for credit, many areas of the market will not become liquid unless a major new buyer is found.

In short, the private sector does not have the appetite for holding these assets in sufficient scale, either directly or indirectly (through ownership of the banks). If, for the sake of argument, banks account for half the gap between write-offs and mark-to-market losses we would still have further write-offs from the banks in the US, Eurozone and UK of \$800 billion. UK banks will account for a significant part of this.

Options for the UK

Will the Asset Protection Scheme work?

The British government's latest approach is to cap these losses by offering UK banks insurance where they will only be liable for the first 10% of the loss. The Asset Protection Scheme has been described as saving the economy from the banks and is a novel approach. At this stage, not all details are available, however, it would seem to be an extremely difficult task to first assess the risk on these securities and then determine a fee that the banks would be willing to pay, without exposing the taxpayer to a potentially massive loss. Details are thin on the ground (the government will announce more in the last week of February) but if the scheme is to be effective it must cover a substantial portion of the toxic assets clogging bank balance sheets. Unofficial estimates of £100 billion (\$140 billion) do not seem unrealistic for the level of coverage needed.

The problem is that the risk of loss at any individual bank is highly correlated with losses at other banks. They will all reflect the state of the UK and world economy and so it is unlikely that one bank makes losses whilst the others sail through. Consequently, any pay out by the government would either be zero or very large.

This binary outcome does not rule out insurance, but it differs from normal insurance principles where, for example, the loss of a ship at sea, should not mean the loss of all vessels. Some storms are big, but not everyone is caught up in them. The lack of correlation between payouts is one of the drivers of insurance markets as it enables the pooling of risk. This factor would seem to be absent from the current situation where everyone is caught up in the same storm, one of the downsides of globalisation. Consequently, everyone sails through or we all sink.

It is possible that confidence in the scheme might feed on itself creating a self-fulfilling recovery in risk appetite and the economy. Then no payouts would be needed. However, this seems wishful thinking and perhaps it is not surprising that at least one senior official has said publicly that the Asset Protection Scheme might not work.

***High risk of bank
nationalisation remains***

All this suggests that we are in for a period where the government sets to work on the new insurance scheme, finds it unworkable and then has to announce the nationalisation of much of the banking sector. Without wishing to be too precise this could be on February 26th when RBS announces its full year results. The result will probably be nationalisation of RBS and possibly Lloyds, followed by the creation of a bad bank to buy toxic assets off the remaining UK banks.

Such an outcome could well prove to be the turning point in the crisis by providing the foundations for a resumption of lending. However, in the near term it is likely to mean further downward pressure on sterling accompanied by upward pressure on gilt yields.

Forecast Summary

I. Forecast summary - Schroders

Real GDP

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	1.3	-1.4	-1.8	0.9	2.3
UK	5.8	0.7	-2.0	-2.2	0.5	0.6
Eurozone	25.5	1.2	-0.7	-1.4	0.8	0.8
Japan	9.2	0.6	-0.6	-1.7	0.8	1.1
Australia	1.9	2.5	1.5	0.9	2.0	2.4
OECD	71.4	1.2	-1.0	-1.6	0.8	1.5
China	7.1	9.1	7.0	7.4	8.0	8.4
Emerging*	28.6	6.3	3.5	2.9	4.5	4.7
World	100.0	2.6	0.3	-0.3	1.9	2.4

Inflation CPI

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	3.8	0.4	-0.5	1.5	2.0
UK	5.8	3.6	2.0	1.0	1.5	1.9
Eurozone	25.5	3.3	2.0	1.0	2.0	1.7
Japan	9.2	1.7	-0.2	-0.4	0.4	0.0
Australia	1.9	4.5	0.0	2.6	2.2	2.5
OECD	71.4	3.3	1.0	0.3	1.5	1.6
China	7.1	5.9	3.0	1.2	4.0	2.0
Emerging*	28.6	7.9	3.6	5.1	4.1	4.7
World	100.0	4.7	1.7	1.6	2.3	2.5

* **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	28.9	1.00	0.25	1.48	0.25	2.40
UK	5.8	2.00	0.50	1.67	0.50	2.74
Eurozone	25.5	2.75	0.50	1.89	0.50	2.72
Japan	9.2	0.10	0.10	0.52	0.10	0.75
OECD	69.5	1.61	0.34	1.52	0.34	2.33

Market from forward futures strip as at 23/01/2009

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

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

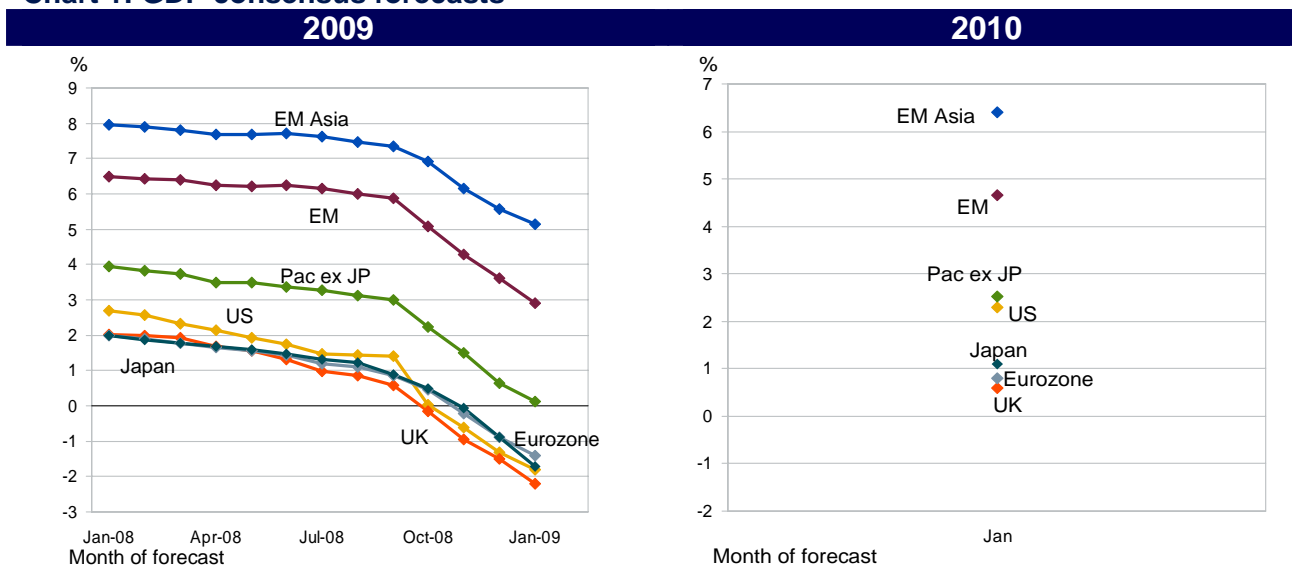
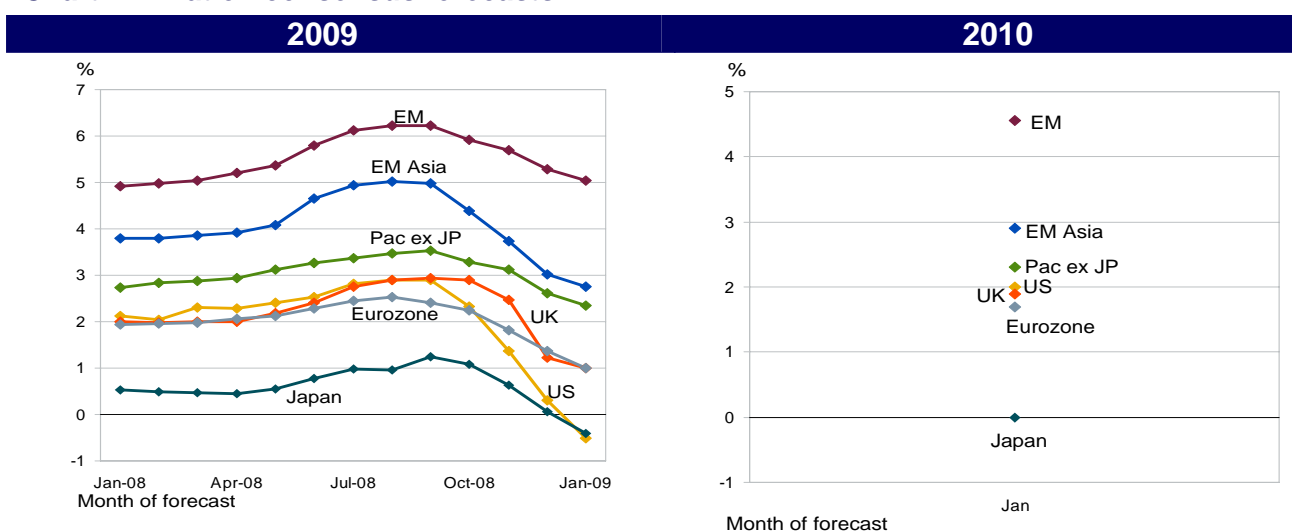


Chart 2: Inflation consensus forecasts



Source: Consensus Economics (January 09), 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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