

Schroders

Economic and Strategy Viewpoint

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Few glimmers of light pierce the gloom

- **Economic data remains poor with employment and house prices continuing to fall sharply. Economies exposed to international trade have been particularly hard hit with Germany and Japan the worst performing of the G7. Data in the Eurozone has been particularly weak. Inventories have built up in the US, signalling a period of further falls in production as companies meet demand from their stocks of unsold goods.**
- **Despite the gloom, we would highlight the benefit to household cash flow from lower inflation, falls in interest rates and fiscal stimulus. Although financial markets seem to have decided that nothing will turn the economy we would expect some improvement in the tone of data given the amount of cash being pumped into the economy.**
- **Markets remain in risk averse mode with equities falling and gold rising in value (see chart). The focus of attention remains on the state of the financial sector and how the authorities can plug the gap on balance sheets without taking control of the banks. The UK government's insurance scheme may prove to be the only way out of the morass, but it represents a massive transfer of risk to the taxpayer. Even if it does work, UK borrowers are still likely to face difficulties accessing capital given the departure of foreign lenders.**

Forecast summary (page 6)

Risk aversion returns: equities fall while gold surges



Source: Thomson Datastream as of 25/02/09



Global

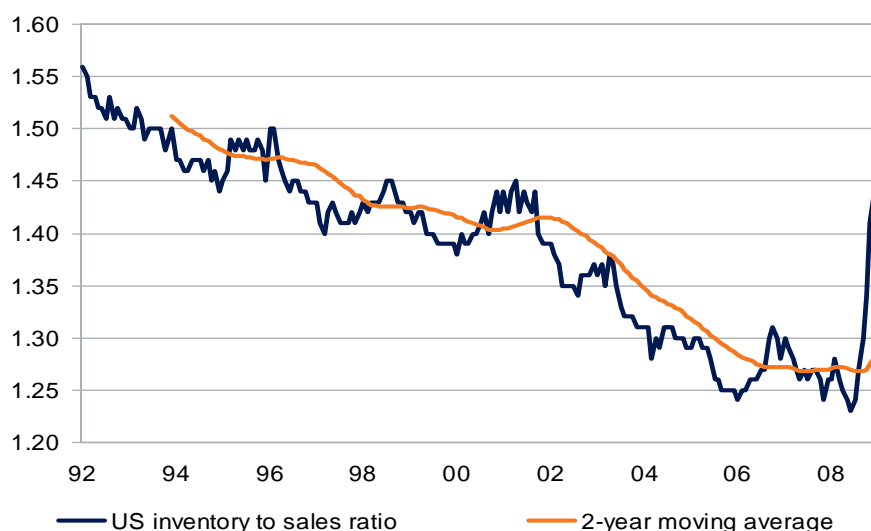
Worse performance on record for G7 GDP as exports collapse

Official figures confirmed that global activity plunged in the final quarter of last year. We estimate that G7 GDP fell at an annualised rate of nearly 6.5%, the largest decline since records started in 1960. Surprisingly, it was not those at the forefront of the credit crunch, the UK and US, which suffered the most. Each of the major economies experienced a fall in output with the worst affected being those who are most dependent on trade. For example, Japan experienced a 12.7% fall in GDP and Germany 8.2% annualised in the fourth quarter as net exports dragged on activity. More broadly, the trade dependent economies of Korea and Taiwan experienced enormous declines of 20.8% and 19.8% respectively (fourth quarter GDP annualised).

By contrast, net exports held up better in the US which experienced a more modest fall in GDP of 3.8% annualised. These figures highlight the interdependence of the world economy and vulnerability to a decline in US import demand. The collapse in trade finance has been a significant factor and it is also no coincidence that Japan and Germany are two of the world's largest carmakers (an industry which has also suffered from a loss of credit provision). For Japan, there has been the added pressure from the appreciation of the Yen over the past year, while German and Eurozone exports are particularly exposed to the downturn in Central and Eastern Europe.

One consequence of weaker demand has been a build up of inventory and while companies have made efforts to reduce this, they have been unable to prevent a significant rise in the inventory to sales ratio, which is at its highest level since 2001. This spells weakness ahead as companies slow production and meet demand from their stock of unsold goods. Industrial production and commodity prices (primarily metals) will bear the brunt of this.

Chart 1: Inventories pile up in the US



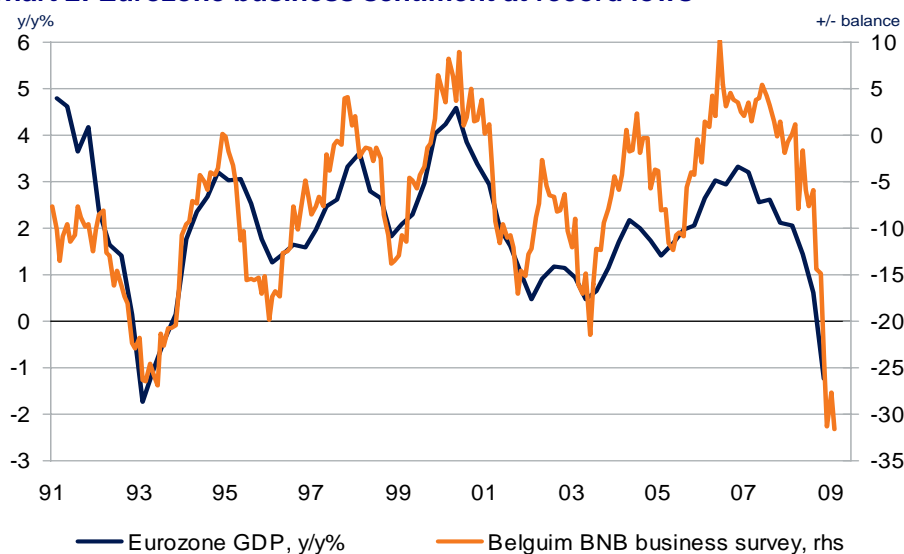
Source: Thomson Datastream as of 25/02/09

Some straws in the wind

Although the outlook remains poor, there have been one or two glimmers of light. Purchasing Managers indices (PMI's) picked up in January led by the US, China and India. Orders rose and the global PMI ticked up as both the manufacturing and service sectors improved. This suggests that the rate of decline may be stabilising. On the consumer front, confidence remains poor, but retail sales did bounce in the US and in the UK in January.

Nonetheless, the picture is still pretty dark. Employment and house prices continue to fall sharply in the US and UK. Surveys of banks show that there has been no loosening of credit in the US or Europe over the past three months. Figures in the Eurozone remain particularly bleak with the region failing to share in the improvement in PMI's reported above. The BNB survey, which closely tracks Eurozone GDP, fell to a record low in February (chart 2).

Chart 2: Eurozone business sentiment at record lows



Source: Thomson Datastream as of 25/02/09

Note: Pre-1995 Eurozone GDP calculated by Datastream

Policy action

Three reasons to look for a near term bounce

Although the headwind from the credit crunch remains strong, looking ahead we would not be surprised to see a modest improvement in the tone of data. This view is based on three factors.

- First, the fall in commodity prices and inflation is providing a cash flow boost to consumers. We estimate this to be worth just under 2% of disposable income to US households.
- Second, there is some evidence that monetary policy is gaining traction with borrowing costs falling. For example in the UK over the past year, we have seen a decline of 34% in mortgage interest payments to existing borrowers, a factor which is driving the RPI measure into negative territory. Mortgage rates in the US have also fallen and we have seen an easing in the cost of capital to companies in the credit markets.

- Third, fiscal policy will remain expansionary. President Obama's fiscal package will inject \$787 billion (5.5% GDP) into the economy over the next two years. The Congressional Budget Office (CBO) estimates that this will deliver a stimulus to activity relative to base of between 1.4% and 4.1% of GDP by the end of this year and between 1.2% and 3.6% of GDP by the end of 2010. The range reflects the uncertainty over multiplier effects, particularly for tax cuts where a significant proportion could be saved.

It might be thought that the prospect of such stimulus would have markets looking for recovery, but instead we have seen the S&P500 heading back to the lows of last November. Risk aversion remains high and gold has surged in value (chart on front page).

In part, this reflects scepticism about the ability of policy to turn the economy around. We do not believe that fiscal stimulus alone will generate a sustainable recovery, nor do we see quantitative easing, where the central bank boosts the money supply, as a silver bullet. Nonetheless, markets seem particularly dismissive of policy makers' efforts at present and unwilling to wait for action to take effect.

Plugging the gap in balance sheets without nationalising the banks

The other reason for market weakness has been the ongoing problems in the banking sector (see charts 3 and 4 on next page). We highlighted the \$2 trillion gap between the current level of write-offs and official estimates in last month's Viewpoint¹. An indication that at \$1 trillion of write-offs, we are only a third of the way through the process of cleaning up bank balance sheets. If all this were to be written off today, the banks would clearly be bust. In the absence of private capital, the gap has to be filled by the government.

Markets recognise this and have done for some time. The problem now is that the terms of a solution are being determined and investors are fearful that they will be wiped out. Equity investors are already resigned to this fate, but there is uncertainty surrounding the treatment of holders of bank debt. Will they also lose everything or experience a major impairment of their holdings? Since these assets were deemed lower risk, there is the danger of inflicting massive damage on pension funds and insurance companies. Remember it was the loss of the entire capital structure at Lehman Brothers, which contributed to the rise in risk aversion last September.

Somewhat reassuringly, governments also seem to recognise this threat and have repeatedly declared that they do not want to take control of the banks. The challenge then is to inject significant sums of capital without taking ownership of the banks, while at the same time protecting the interests of the taxpayer. This may prove a challenge too far and we may still see full nationalisation.

The one solution, which may work, is the scheme where the government insures selected assets on bank balance sheets in return for a premium. In this way, capital can be injected into the banks (without taking control) who can then restructure themselves as the insurance scheme puts a floor under the value of the balance sheet. We are still sceptical of this as it still involves assessing the value of assets and puts massive amounts of taxpayers'

¹ See Schrodgers Economic and Strategy Viewpoint, January 29th 2009.

money at risk. However, it may prove the only way of bringing the banks back from the dead without nationalisation.

Chart 3: Global write offs, capital raised, job losses

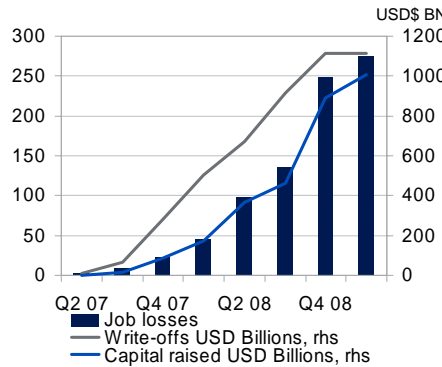
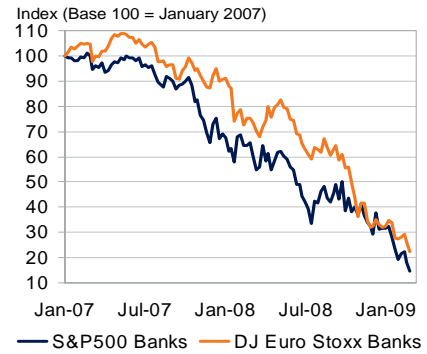


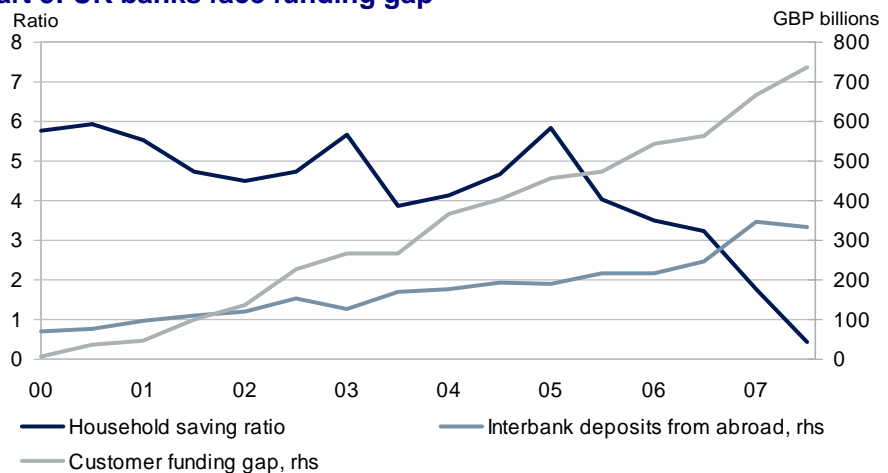
Chart 4: US and European Banks' share prices



Source: Thomson Datastream, Schroders as at 25/02/09

Solving the problem of keeping the banks running without taking ownership of them will help, but for an economy like the UK which has been heavily dependent on foreign capital it will not be the end of the story. UK banks had been able to sustain strong rates of lending by increasingly tapping into the wholesale markets during the boom. The fall in domestic savings meant that retail deposits could not keep pace (chart 5).

Chart 5: UK banks face funding gap



Source: Financial Stability Report, 28 October 08, Bank of England, Data updated to 30 June 08. Note: Customer funding gap is customer lending less customer funding, where customer refers to all non-bank borrowers and depositors. UK household savings as % of post-tax income. Data on foreign interbank deposits excludes Nationwide.

Freeing up balance sheets should help bring the wholesale markets back. However, around half the wholesale deposits raised in the UK came from abroad and this flow of capital has ceased. During a crisis everyone goes home to what they know best and banks are no exception. Foreign banks are no longer lending in the UK. This means that the shortage of credit is likely to persist even when the domestic lending markets have revived. The credit crisis has exposed a fault line in the UK's lack of domestic savings and dependence on foreign capital.



Forecast Summary

I. Forecast summary - Schroders

Real GDP

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	1.3	-1.4	-2.1	0.9	2.0
UK	5.8	0.7	-2.0	-2.6	0.5	0.6
Eurozone	25.5	0.7	-0.7	-2.0	0.8	0.7
Japan	9.2	-0.7	-0.6	-3.8	0.8	0.8
Australia	1.9	2.2	1.5	0.3	2.0	1.9
OECD	71.4	0.8	-1.0	-2.3	0.8	1.2
China	7.1	9.1	7.0	7.0	8.0	8.3
Emerging*	28.6	6.3	3.5	2.6	4.5	4.5
World	100.0	2.4	0.3	-0.9	1.9	2.2

Inflation CPI

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	3.8	0.4	-0.9	1.5	1.7
UK	5.8	3.2	2.0	1.0	1.5	1.9
Eurozone	25.5	3.3	2.0	0.8	2.0	1.6
Japan	9.2	1.4	-0.2	-0.8	0.4	-0.2
Australia	1.9	4.4	0.0	2.3	2.2	2.4
OECD	71.4	3.3	1.0	0.0	1.5	1.5
China	7.1	1.1	3.0	0.3	4.0	1.6
Emerging*	28.6	7.9	3.6	4.8	4.2	4.4
World	100.0	4.6	1.7	1.3	2.3	2.3

* **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	1.60	0.25	2.42
UK	5.8	2.00	0.50	1.94	0.50	2.64
Eurozone	25.5	2.75	0.50	1.74	0.50	2.39
Japan	9.2	0.10	0.10	0.53	0.10	0.70
OECD	69.5	1.61	0.34	1.54	0.34	2.20

Market from forward futures strip as at 25/02/2009

Source: Schroders, Datastream, IMF, Consensus Economics (February 09)

Note: Next forecast update will be made available in March 09

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

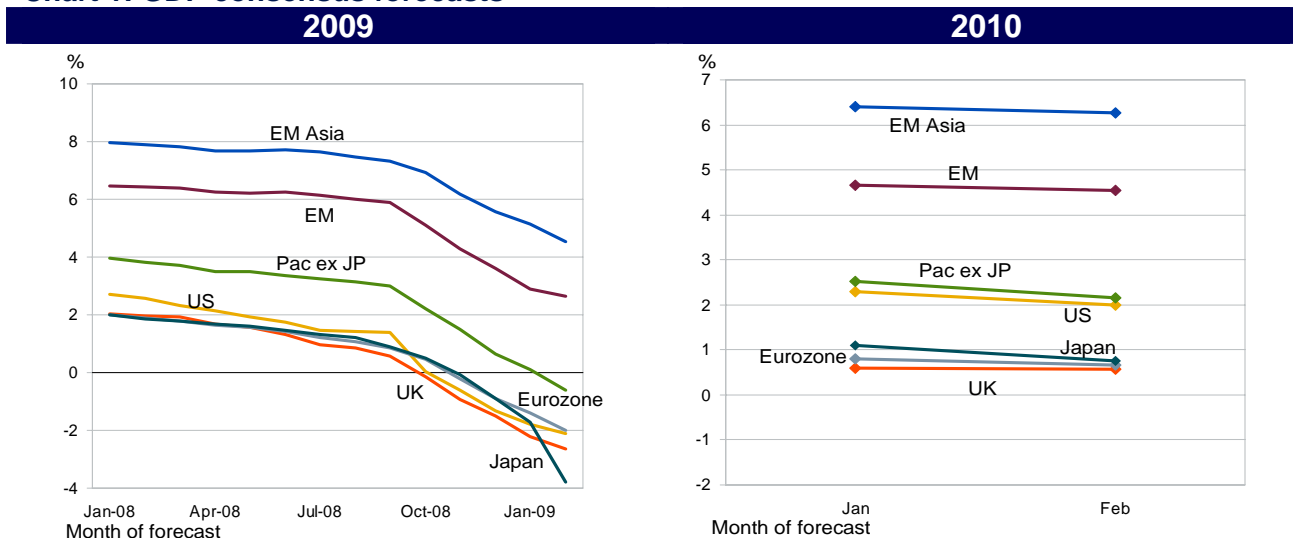
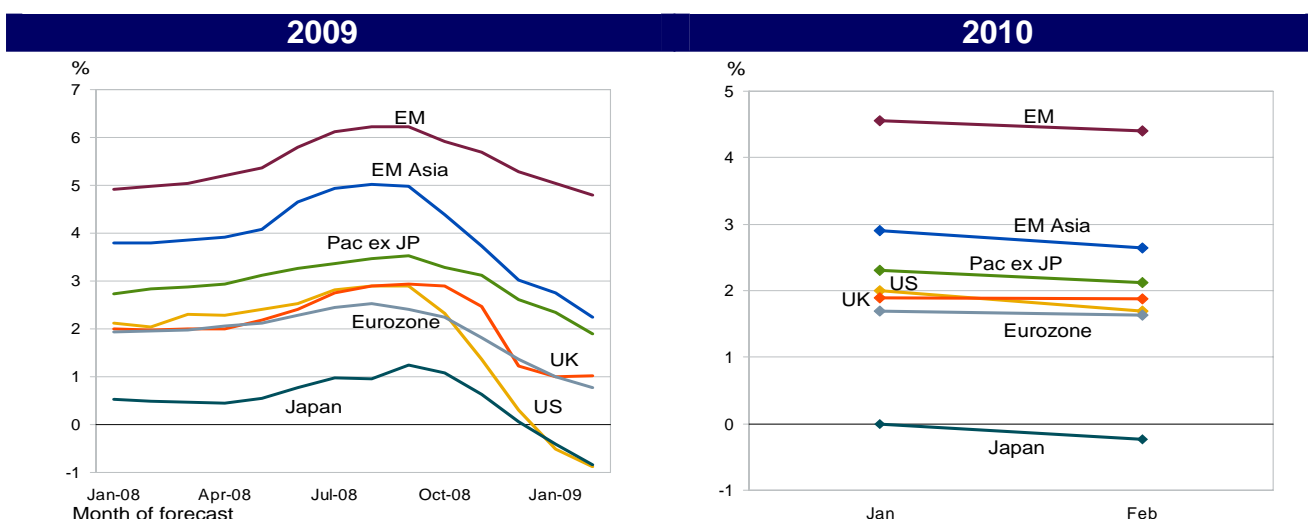


Chart 2: Inflation consensus forecasts



Source: Consensus Economics (February 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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