

Schroders

Economic and Strategy Viewpoint

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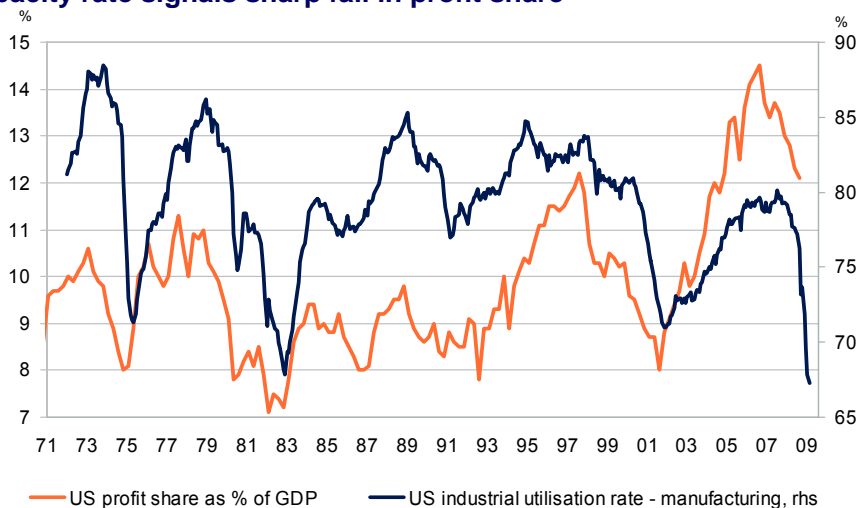
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Global recession will bring massive profit squeeze

- The forecast for global growth has been cut significantly with projections for both the OECD and emerging markets lowered for 2009. The downturn will generate tremendous slack in the world economy sending prices lower and the US into deflation. For 2010, we have built a modest recovery into our baseline forecast to reflect the impact of fiscal and monetary policy easing and on this outlook deflation should not become entrenched.
- The risks, however, are firmly skewed to the downside and we put a 25% probability on a slump type scenario with GDP falling for two consecutive years. The biggest unknown in the forecast is the impact of Quantitative Easing and we would not rule out this being successful, particularly in the UK where the government has considerable control over the banking sector by virtue of its stakes in RBS, Lloyds, Northern Rock and Bradford and Bingley.
- Optimism that the next part of the Financial Stability Plan in the US will provide relief to the economy is currently encouraging markets to look through the downturn in activity. Nonetheless, our analysis highlights just how much earnings are likely to drop in an environment where both output and the profit share are falling. There is little reason why the biggest recession for more than fifty years should not lead to the greatest fall in profits. There is a good chance that reported earnings on the S&P disappear altogether this year.

Forecast summary (page 9)

Capacity rate signals sharp fall in profit share



Source: Thomson Datastream, 24 March 2009

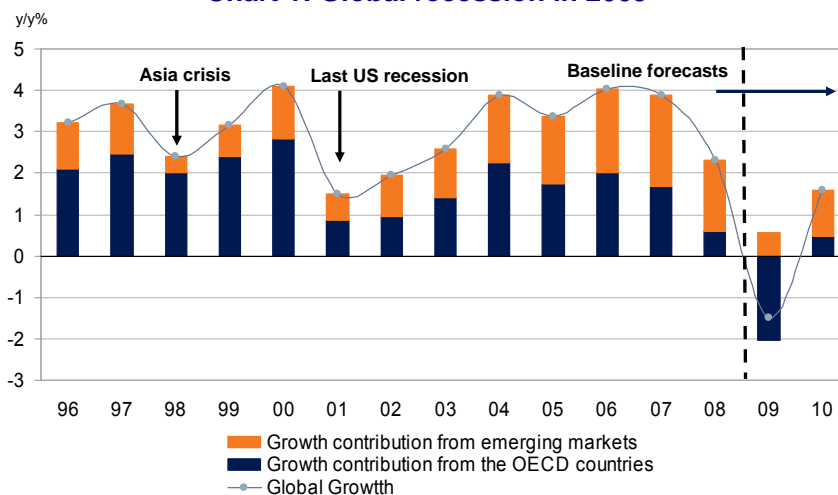
Global

Global recession will bring massive profit squeeze

Global output set to fall significantly in 2009...

The outlook has darkened considerably since our last quarterly review in December. Global GDP is now expected to decline by 1.5% in 2009 as a result of a deeper downturn in the OECD and a more marked slowdown in the Emerging markets (chart 1). Hopes that Europe and Asia might decouple from the US have been dashed and those countries dependent on trade are amongst the worst affected. The global GDP forecast has been cut by 1.6 percentage points (pp) and is now 0.6 pp below consensus (see table 1).

Chart 1: Global recession in 2009



Source: IMF, Consensus Economics, Schroders, 27 February 2009

..bringing inflation down and causing deflation in the US

Alongside weaker growth goes lower inflation. The forecast has also been driven down by a lower profile for oil prices and we now expect the OECD to experience a fall in consumer prices this year. What the forecast does not show is the steady decline in core inflation and we expect this measure to fall close to zero by the end of the year before turning negative in 2010 - i.e. deflation is the baseline view.

On the interest rate front, the changes compared to the last Cyclical Market Forum (CMF) have been in Europe with rates falling even faster than previously expected in the UK and Eurozone.¹ Our forecasts for rates are below market expectations (although this may be by less than suggested by futures rates given the premium on LIBOR). The issue for policymakers in the US and UK has gone beyond interest rates and is now about how much Quantitative Easing (QE) should be carried out to lift economic activity (see below for more on the impact of QE).

¹ The Cyclical Market Forum is our quarterly asset allocation meeting.

Table 1: Forecasts for 2009: compared to last Review and consensus

	Last Review	Latest	Revision	Consensus	Difference
Real GDP					
OECD	-1.0	-2.8	-1.8	-2.3	-0.6
Emerging	3.5	2.0	-1.5	2.6	-0.6
World	0.1	-1.5	-1.6	-0.9	-0.6
Inflation CPI					
OECD	1.2	-0.2	-1.4	0.0	-0.2
Emerging	3.4	2.3	-1.1	4.8	-2.5
World	1.7	0.5	-1.2	0.5	0.0
Interest rates – end year				Market	
US	0.25	0.25	0.0	1.55	-1.3
UK	1.50	0.50	-1.0	2.01	-1.5
Eurozone	2.00	0.50	-1.5	1.79	-1.3
Japan	0.10	0.10	0.0	0.53	-0.4

Last Review forecast : December 9th 2008

Source: Schroders, Consensus Economics (Feb. 09)

Not giving up on recovery

Lower inflation plus fiscal and monetary stimulus to boost growth

The baseline view still contains a modest recovery in activity in 2010 based on 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 activity, we would expect some improvement in the tone of data given the amount of cash being pumped into the world economy. Firmer demand should allow firms to reduce excess inventory providing a base for a recovery in output.

There has already been some evidence of firmer consumption in the US and UK in December and January as households responded to lower inflation. This is likely to be followed by further gains as tax cuts and public spending increases come through in the US. According to Congressional Budget Office (CBO) estimates, the effect of the stimulus package on the level of US real GDP at the end of 2010 could range from about 1 percent to a little more than 3 percent (relative to a baseline forecast that does not include the stimulus). They estimate that these effects on output would leave the corresponding unemployment rate between 1/2 pp and 2 pp's lower at the end of next year than in the baseline forecast.

Furthermore, an easing in money market spreads and decline in mortgage rates following action by the Federal Reserve to buy large amounts of agency mortgage backed securities (MBS) will also work through to activity. Credit flow should also be improved by the extension of the Term Asset-Backed Securities Loan Facility (TALF), to a wider range of Asset Backed Securities from March 25th. The TALF has the potential to generate up to \$1 trillion of lending for businesses and households.

A known unknown: Quantitative easing

Bank of England steps into the unknown

Assessing the impact of QE is problematic. Economists have a reasonable idea of the impact of changes in interest rates on the economy through experience and econometric models. The same cannot be said of QE. No one knows the impact of a £75 billion increase in base money on the UK economy as announced by the Bank of England’s Monetary Policy Committee on 5th March.

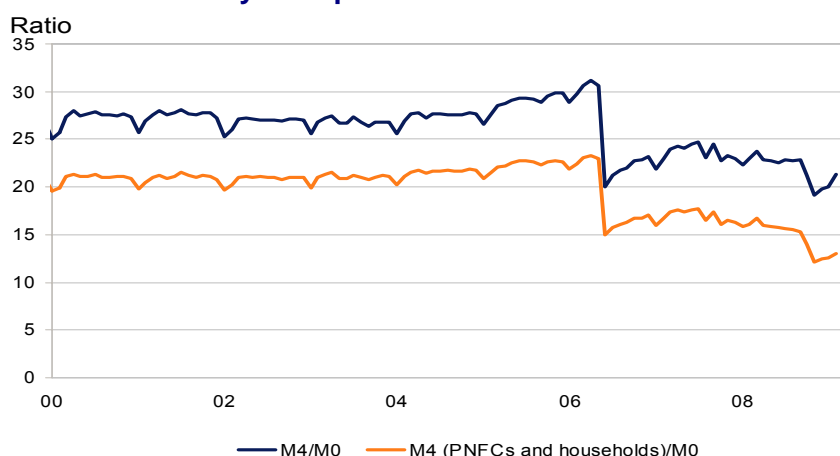
The difficulty is knowing what will happen to the money once it is injected into the economy. For example, if the Bank of England buys a gilt from a pension fund the increase in bank reserves may prompt banks to increase their lending in order to maintain their ratio of reserves to their balance sheet. This ratio (known as the money multiplier) is currently around 12 and therefore a £75 billion rise in reserves would prompt a colossal £900 billion rise in lending to the private sector, increasing M4 loans by more than 50%.

However, the money multiplier has been falling sharply as banks have become more risk averse and held more safe and liquid assets in reserves relative to overall lending. Banks will also be cautious as the rise in deposits may prove temporary. For example, the pension fund who sold the gilt might then decide to restore its gilt weighting by participating at the next gilt auction, thus running down its cash deposits. However, the government would then spend the proceeds of the sale, thus putting the money back into the economy. Thus, the rise in bank deposits would be permanent, only it might take time before banks registered the fact and acted on it.

QE will only work if banks are willing to lend and the private sector willing to borrow

The most recent empirical evidence suggests that QE has little effect as the money multiplier falls. This of course was the experience in Japan when the government pumped nearly 30% of GDP into bank reserves with remarkably little effect on the economy. Arguably, this was because the banking sector was in no state to increase lending and that after nearly a decade of recession and deflation there was little appetite to borrow. The prospects in the UK are a little better as the government has considerable control over the banking sector by virtue of its stakes in RBS, Lloyds, Northern Rock and Bradford and Bingley. However, although It can direct the banks to lend with unemployment rising and house prices falling, demand may well prove disappointing. The key point is that for QE to work in any economy, the banking system must be prepared to lend and people willing to borrow.

Chart 2: UK Money multiplier



Source: Bank of England, Schroders, 31 January 2009
 Note: Private non-financial companies (PNFCs)



Process of mending the banks has become a political process in the US

The same applies in the US where arguably the banking sector has further to go before it is even in a position to lend. At this time, we are waiting for the results of the “stress tests” which will determine how much capital banks will need to raise. They will then have 6 months to tap the private sector for funds after which time they can turn to the government.

The market has already given its reaction by dumping bank stocks and it would almost seem to be pointless to seek private capital. Consequently, the US Treasury will step in and the question will be whether they can get the funds from Congress to nationalise a number of banks. Once all this is in place, which could be some months away, the benefits of QE in terms of greater lending should begin to be felt.

Given the time, which this is likely to take, and the almost inevitable outcome it is not surprising that some are calling for a faster resolution in the form of temporary nationalisation. We would agree with *The Economist* magazine who recently argued for a process which “involves several steps: ascertain which banks are insolvent, take them over, sever the most toxic assets and sell them over time or hold them to maturity. The good parts would be sold to the public or a strategic buyer as quickly as is feasible. These healthy banks would be fit to lend, benefiting the overall economy²”.

Risk scenarios

To capture the uncertainty surrounding the baseline we specify two scenarios: recovery and slump. The former has a return to above trend growth in 2010, while the latter is for another year of recession in 2010. These two outcomes capture the range of outcomes likely as a result of uncertainty over the impact of policy. At this point, we would put a 65% probability on the baseline, 25% on slump and 10% on recovery.

Implications for corporate profits

Corporate earnings fell sharply in Q4 last year

At the time of writing 98% of companies in the S&P500 have reported fourth quarter earnings per share (EPS). The results have been poor with reported earnings at minus \$23 per share and operating earnings at minus 10 cents. Losses were primarily driven by financials, although consumer discretionary, energy and materials sectors also recorded falls in reported EPS as consumer spending and commodity prices slumped. For 2008 as a whole reported EPS were \$15.1 per share (-77% y/y) while operating EPS came in at \$49.5 (-40% y/y). The gap between the two reflects the elevated level of write-offs and provisions from the financial sector.

Incorporating the Q4 earnings figures means we now have a higher PE even though the market has fallen significantly. For example, at 770 on the S&P500, the PE based on calendar year 2008 reported EPS is 51.

Using our model of the profit share we have produced an EPS forecast based on costs and prices and capacity utilisation. The low level of capacity use and the forecast for deflation in 2010 means that margins are under considerable pressure throughout the forecast period.

² The Economist February 28th 2008.

More bad news to come on corporate profits as output falls and the profit share contracts

The baseline forecast is for economic profits to fall 27% in 2009 and 13% in 2010. The quarterly profile suggests no improvement until 2010H2. This translates into a similar profile for operating EPS. For reported EPS our global analysis suggests we are only a third of the way through the total level of write-offs in the financial sector. US banks are probably further along, but even if they are half way through we are still likely to see considerable write-offs this year and next. On top of this will come the normal write-offs from the non-financial sector as a result of the recession. On this basis reported EPS come in at just over \$20 this year and \$21.4 in 2010. This represents a rise of more than one third on 2008, but is considerably below market expectations of \$34.7 and \$41.5 respectively (see table 2).

Table 2: US profits, EPS and PE ratio

US	2008	2009f	2010f
Economic profits			
y/y%	-12.6	-26.9	-13.0
S&P 500 EPS			
Operating \$	49.5	40.5 (49)	35.3 (48.4)
y/y%	-40.0	-18.1	-13.0
Reported \$	15.1	20.1 (34.7)	21.4 (41.5)
y/y%	-77.2	33.3	6.4
S&P 500 PE market at:	770	20 March 2009	
<i>Based on operating EPS</i>	15.6	19.0	21.8
<i>Based on reported EPS</i>	51.0	38.3	35.9

Source: Schroders, S&P. Figures in brackets are market estimates as collated by S&P

It is possible that we are being too pessimistic on EPS, but everything suggests that this will be the worst profits recession in the post war era. For example, the level of capacity utilisation indicates that the profit share is set to drop significantly (chart on front page). On our base case, from 12% of national income today to 9% by year-end. Prospects for financials may be better given the low starting base, but as discussed above, shareholders face the prospect of either dilution or being wiped out before any recovery can begin.

Our forecasts for growth and inflation have been translated into an outlook for earnings and the PE for the base case, recovery and slump scenarios. (see table 3 on next page). Based on reported EPS, each forecast has EPS rising and hence the PE falling from its current estimated level of 51.

There is a risk that earnings disappear altogether in 2009

However, only the recovery scenario PE could be described as fair value, the base and slump are expensive based on an S&P500 at 770. It is likely that the trailing PE will rise to triple digit levels and even that earnings could disappear altogether. The key issue will be whether investors can look through this to a higher level of operating earnings, something which will require there to be an end in sight for bank write-offs.

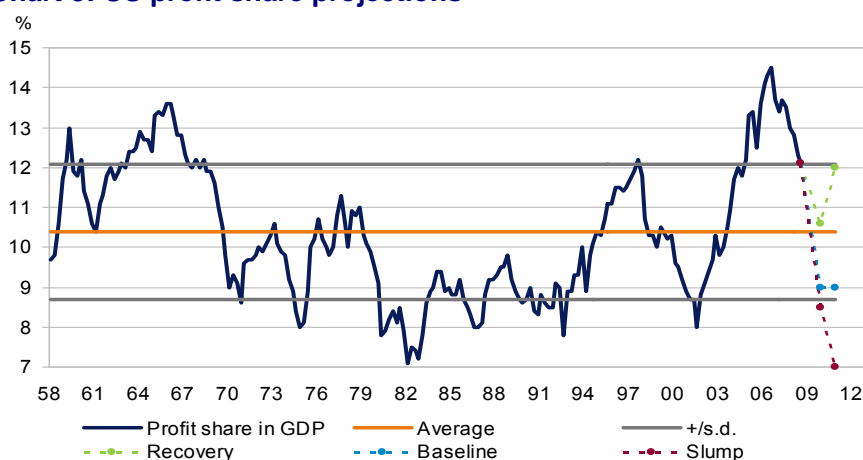
Table 3: S&P500 EPS and PE ratio under different scenarios

	Reported EPS			PE*		
	Today	End '09	End '10	Today	End '09	End '10
Base	100.0	133.3	141.8	51	38.3	35.9
Recovery	100.0	162.1	201.2	51	31.5	25.3
Slump	100.0	130	117.4	51	39.2	43.4
PE based on S&P500 at		770.0		on 20th March 2009		

Source: Schroders

Note: PE today is based on reported earnings for calendar 2008 (This has yet to be incorporated in the trailing PE ratio quoted by Thomson Datastream).

Chart 3: US profit share projections



Source: Thomson Datastream, March 2009, Schroders forecast to end-2010

Chart 4: US S&P 500 PE projections



Source: Thomson Datastream, Schroders, March 2009, forecast to end-2010 S&P at 770

Why it is different this time

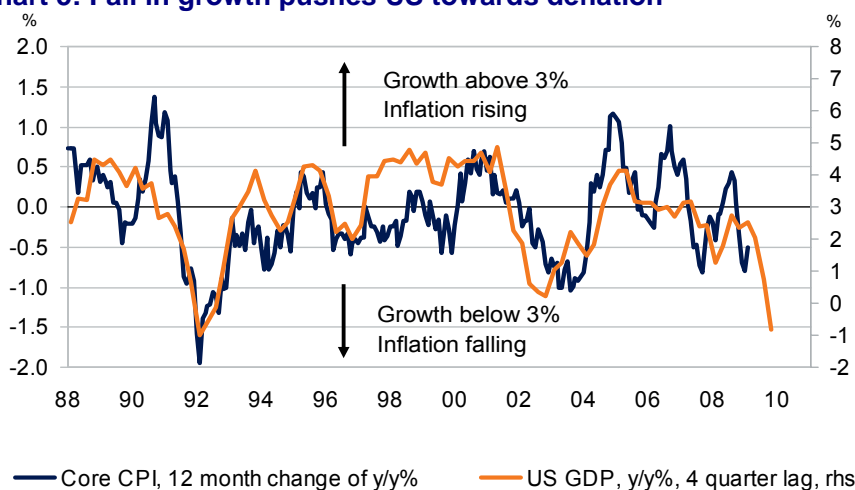
Excess capacity means intense competition and a squeeze on margins, it also means falling inflation. Capacity utilisation can be thought of as a proxy for the economy wide output gap which drives inflation. Simply taking the lag between inflation and growth suggests that deflation is now only a matter of time in the US (chart 5 on next page).



This highlights the key difference between this cycle and the others in the post war period. Previous recessions were a necessary means of bringing inflation down. Once prices had been brought back under control, interest rates could be cut and growth restarted. Today inflation is beaten and the problem is how to get the economy going again.

Such a difference accounts for why markets have behaved differently this cycle. There is little willingness to look through the downturn when the recovery mechanisms are broken or impaired. Consequently, it is likely that equity markets will need hard evidence of economic revival before embarking on a sustainable recovery. At present equities are rallying on the back of the latest announcement from the US Treasury on the public-private partnership to rid banks of their toxic assets. However, a sustained recovery will require evidence that this will deliver visibility on earnings.

Chart 5: Fall in growth pushes US towards deflation



Source: Thomson Datastream, 23 March 2009
 Latest US CPI (ex food and energy) is 1.8% February 2009.

Forecast Summary

I. Forecast summary - Schroders

Real GDP

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	1.1	-2.7	-2.1	0.6	2.0
UK	5.8	0.7	-3.0	-2.6	0.5	0.6
Eurozone	25.5	0.8	-2.5	-2.0	0.7	0.7
Japan	9.2	-0.9	-4.5	-3.8	0.8	0.8
Australia	1.9	2.5	-0.5	0.3	1.5	1.9
OECD	71.4	0.7	-2.8	-2.3	0.7	1.3
China	7.1	9.0	6.5	7.0	7.5	8.3
Emerging*	28.6	6.3	2.0	2.6	3.9	4.5
World	100.0	2.3	-1.5	-0.9	1.6	2.2

Inflation CPI

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	3.8	-1.0	-0.9	0.4	1.7
UK	5.8	3.6	1.0	1.0	1.4	1.9
Eurozone	25.5	3.3	0.5	0.8	1.0	1.6
Japan	9.2	1.7	-1.0	-0.8	-0.2	-0.2
Australia	1.9	4.5	2.0	2.3	1.8	2.4
OECD	71.4	3.3	-0.2	0.0	0.6	1.5
China	7.1	5.9	3.0	0.3	4.0	1.6
Emerging*	28.6	7.9	2.3	4.8	3.2	4.4
World	100.0	4.7	0.5	1.3	1.4	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	1.55	0.25	2.43
UK	5.8	2.00	0.50	2.01	0.50	2.71
Eurozone	25.5	2.50	0.50	1.79	0.50	2.51
Japan	9.2	0.10	0.10	0.53	0.10	0.71
OECD	69.5	1.52	0.34	1.54	0.34	2.25

Market from forward futures strip as at

26/02/2009

Source: Schroders, Datastream, IMF, Consensus Economics (February 2009)

Baseline - deep recession in 2009

Our forecasts for global growth have been cut further since the last CMF with the world economy now expected to experience an outright drop in output this year. No country or region has been spared the axe and 2009 is expected to be the worst year for OECD growth in the post war period, by far. Emerging markets are hit hard by the decline in trade and experience a year of activity similar to that last seen during the Asia crisis.

Prospects for 2010 are for a modest recovery as monetary and fiscal policy gains traction while the banking system stabilises. Inflation is forecast to fall sharply helped by lower commodity prices and the slack created by the downturn. Both the US and Japan experience deflation. Interest rates are already close to the zero bound in the US and Japan, but are predicted to fall a little further in Europe, before staying low through out the forecast period. Relative to consensus, the baseline is more deflationary with weaker growth and lower inflation.

Growth

- US growth forecast cut to -2.7% for 2009 as the credit crunch forces a de-leveraging of household and corporate balance sheets. Weakness is concentrated in the first half of the year with tax cuts and lower inflation lifting consumer spending in the second half. 2010 brings a modest sub par recovery as the credit crunch eases and monetary policy begins to take effect.
- Amongst the OECD, Japan is forecast to experience the greatest fall in GDP this year, a reflection of the hit to global trade. Sluggish recovery forecast for 2010. Forecasts for the UK and Eurozone cut further for 2009 to reflect the poor start to the year and weaker external environment.
- OECD activity now forecast at -2.8% in 2009 compared to a consensus of -2.3%.
- Emerging market growth is hit by weaker external demand and pressures on those economies with balance of payments deficits particularly in Central and Eastern Europe.
- Global growth to decline by 1.5% in 2009 (consensus -0.9%) from 2.3% in 2008 and recover to 1.6% in 2010, below the consensus estimate of 2.2%.

Inflation

- The combination of a significant output gap and lower energy prices push inflation forecasts for 2009 down to -0.2% for OECD and 2.3% for EM, taking global inflation below 1% (after nearly 5% in 2008).
 - Inflation picks up in 2010 in line with higher commodity prices, however core rates drift lower as slower growth creates slack and squeezes pricing power. US core inflation negative in 2010.
- (Note. We use forward futures rates for commodity price assumptions).

Monetary policy

- Central banks ease further in coming months with rates falling to record lows in the Eurozone and UK and quantitative easing in the US and UK. The forecast of weak growth and deflation means no central bank is expected to tighten policy during the forecast period.



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

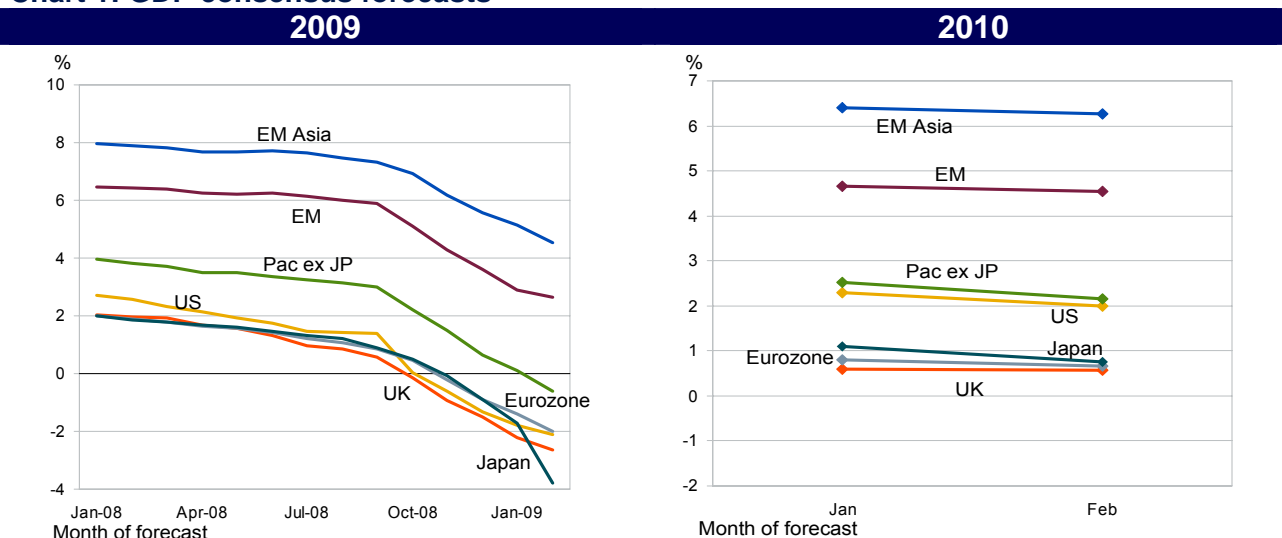
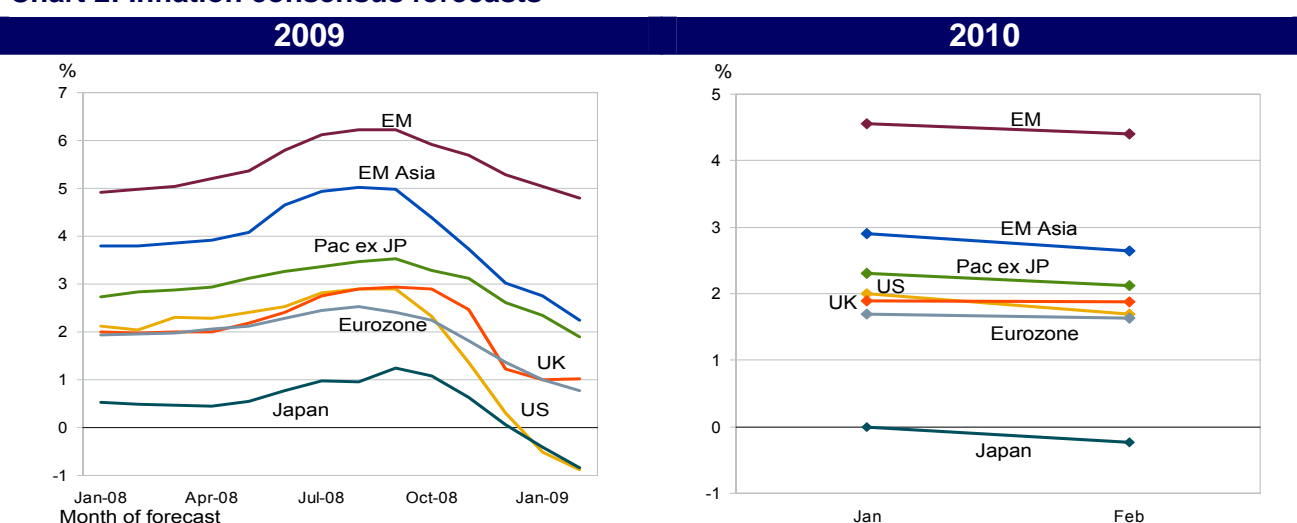


Chart 2: Inflation consensus forecasts



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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