

Schroders

Economic and Strategy Viewpoint

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Spring brings green shoots...

- Risk assets have rallied on evidence that the green shoots of recovery have begun to emerge. Business surveys and Purchasing Managers indices around the world have begun to rise and there are signs that monetary policy is achieving some traction in terms of reducing credit costs.
- The better tone to economic data is likely to continue into the summer as the inventory cycle turns upward and households enjoy the cash flow benefits of looser fiscal and monetary policy. This may give the equity market another leg upward.
- However, faced with the headwind from de-leveraging we doubt that the multiplier effects of policy will be strong enough to support a sustained improvement in final demand. The key difference between this cycle and others in the post war period is the need for balance sheets to be repaired – a process which the IMF recently noted can be drawn out.
- We still believe that the US economy faces a significant risk of deflation and the certainty of a further fall in profits. In addition to living with these perils, financial markets need to be satisfied that the banking sector is adequately capitalised with the first challenge on 4th May with the release of the stress tests on US banks.

... but not for the UK (page 8)

- Downside risks for the UK are materialising in the form of ever worsening public finances and weaker economic growth prospects. We have downgraded our forecast for 2009 and 2010 GDP growth with a view that this will be the deepest and longest recession since the Second World War.
- Job losses continue to rise, although given the current size of falls in output, a big rise in unemployment is inevitable. Average earnings including bonuses were surprisingly weak which raises questions over growing deflationary pressures. We expect RPI inflation to remain negative throughout 2009 before base effects and firmer activity lifts both RPI and CPI indices in the second half of 2010.
- As is the case elsewhere, surveys seem to be pointing to the bottom of the recession being reached sooner rather than later in the UK. Even house price surveys point to a pick up, although we feel the correction in house prices is far from over.

Forecast summary (page 13)



Global

Spring brings green shoots

Risk appetite returns...

Financial markets have brightened over the past six weeks with equity markets enjoying a sharp bounce from the lows of early March with the emerging markets leading the way. Government bond yields have ticked up and risk appetite has improved (see Table 1).

Table 1: The rally in perspective

Asset	Total Return Performance %	
	Year to Date	Market Trough* to 27th April 09
Equity Market		
S&P 500 Index	-4.2	27.1
DJ Euro Stoxx	-2.3	28.1
UK FTSE All Shares	-2.2	19.6
MSCI Emerging Markets	12.6	31.1
Fixed Income		
US 10yr Govt. Yield	-4.3	0.1
US Investment Grade spread	1.4	4.2

*Market trough based on S&P500 as at 9th March 09.

Source: DataStream, Bloomberg, Schroders - As at 27th April 09

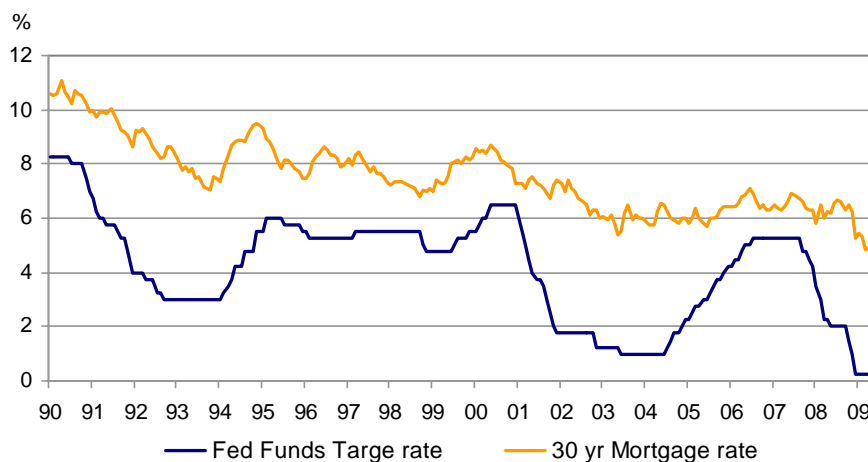
Three factors have been important.

a) Progress on policy

Market rates ease lower...

There is evidence that the Fed's action is beginning to thaw credit markets with fixed mortgage rates declining significantly since the start of the year. The cuts in Fed funds are now delivering declines in mortgage rates comparable to those seen in the 2000-03 cycle (Chart 1). Similarly, credit conditions have begun to ease elsewhere with the terms of mortgage lending easing slightly in the UK and spreads on corporate credit narrowing across Europe.

Chart 1: Fed Funds and Mortgage rates



Source: DataStream, Schroders, as at April 09

Central banks have maintained the policy momentum with the decision by the Fed at the 17th March FOMC meeting to increase its purchases of Mortgage Backed Securities (MBS) and buy Treasury bonds. The move to quantitative easing in the US follows on from the announcement that the Bank of England would buy up to £150 bn of gilts and corporate bonds. And although the G20 conference in London was mostly about announcing existing measures, the increase in reserves for the IMF is positive and will help reduce risk in emerging markets.

In addition, we have had the new TALF¹ and the Public Private Investment Programme in the US. While we can debate whether any of these will work, having initially dismissed all Tim Geithner's efforts, markets now seem more willing to give him the benefit of the doubt.

b) Economic data has improved, or at least stopped getting worse.

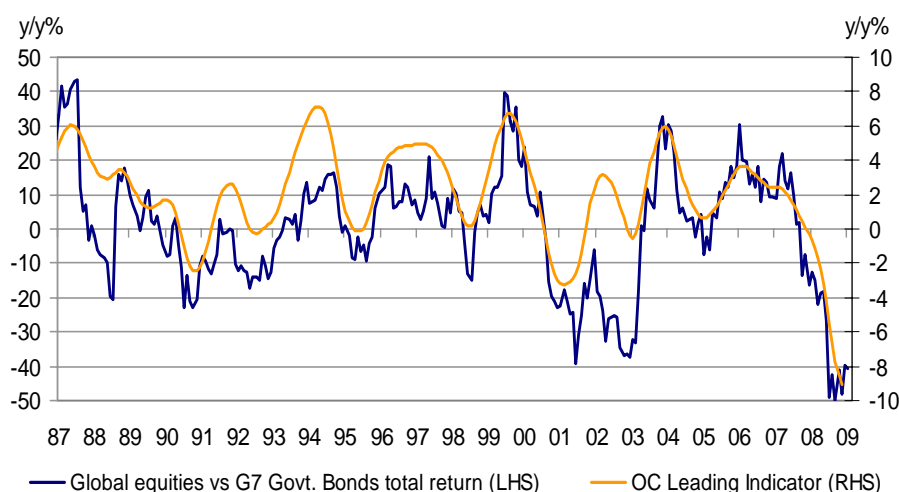
and economic data improves

The US ISM index has risen each month since December and there has been a considerable improvement in its Chinese equivalent. Asian GDP numbers for the first quarter have improved in Korea and Taiwan. The US retail sales numbers have also turned up and with US car sales firmer in Feb and March, consumption is likely to have made a positive contribution to US real GDP in the first quarter. Some economists are upgrading 2009 forecasts for the US and China and consensus forecasts are declining less rapidly.

c) Sentiment had become very depressed

Over the past year, equities had become very depressed relative to bonds underperforming by 50% (Chart 2). Institutional investors have been underweight equities and overweight cash. In this environment where trading volumes are low, it does not take much to generate a rally in markets.

Chart 2: Global equities vs. G7 Govt. bonds return and the cycle



Source: DataStream, Schroders, as at April 09

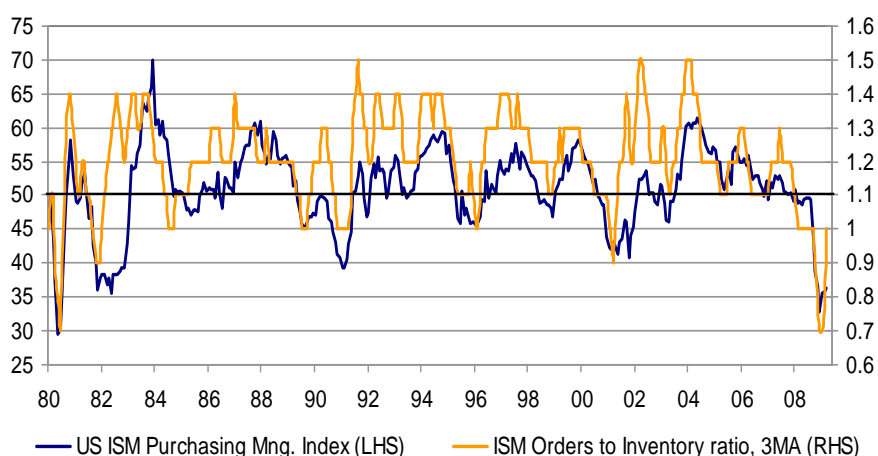
¹ Term Asset-Backed Securities Loan Facility (TALF).

So where to now?

The inventory cycle is turning

It is quite possible that hopes of a recovery continue for a little longer in the near term. The world economy is in the midst of an inventory cycle and, having seen a sharp fall in demand, companies are now clearing their excess inventory of unsold goods (Chart 3). By adjusting output to a lower level, this should set the stage for an upturn in production in coming months. For example, the Honda plant in Swindon was closed for 50 days in February and March to clear inventory, the reopening in April should provide a boost to UK output.

Chart 3: US ISM to improve as inventory turns



Source: DataStream, Schroders, as at April 09

And fiscal policy becoming more expansionary

It is also likely that the recovery could gain some traction as the benefits of tax cuts and lower interest rates kick in. Household cash flows will improve this year. For example, lower mortgage rates, energy prices and the reduction in VAT are worth 3% of disposable income to UK households. US and Japanese households will also benefit from these factors and figures from the IMF suggest that fiscal stimulus will be worth some 2% of GDP in 2009.

Hurdles to overcome

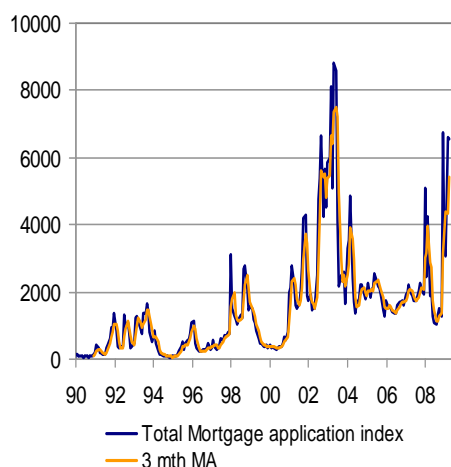
However, there are several hurdles to overcome before we can say that we have really turned the corner.

Sustainable recovery will require an improvement in final demand.

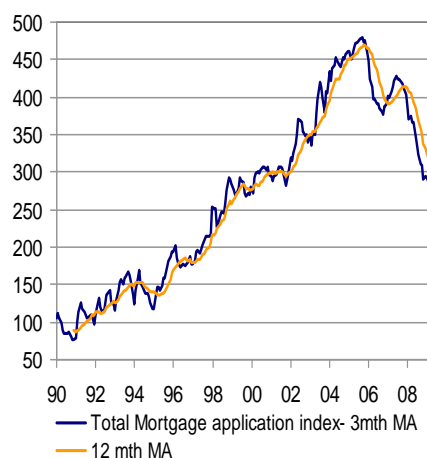
The turn in the inventory cycle and the boost from fiscal policy will only provide a temporary boost to activity in our view. Sustained recovery will require stronger private demand which in turn will require a return to borrowing. Although we are seeing some thawing of lending by the banks, credit conditions remain tight and the willingness to borrow is likely to take time to recover in an environment where unemployment is rising and house prices falling. Thus, despite lower mortgage rates, mortgage applications for house purchase continue to decline in the US (Chart 4).



**Chart 4: US mortgage applications
For refinancing**



For purchase



Source: DataStream, as at April 09

The headwind from de-leveraging is likely to keep final demand weak

The key point is that the household sector in the US and UK is over leveraged as debt to GDP remains close to its record peak of around 100% (Chart 5). Consequently debt reduction and higher savings will remain the driving force for the consumer in the foreseeable future.

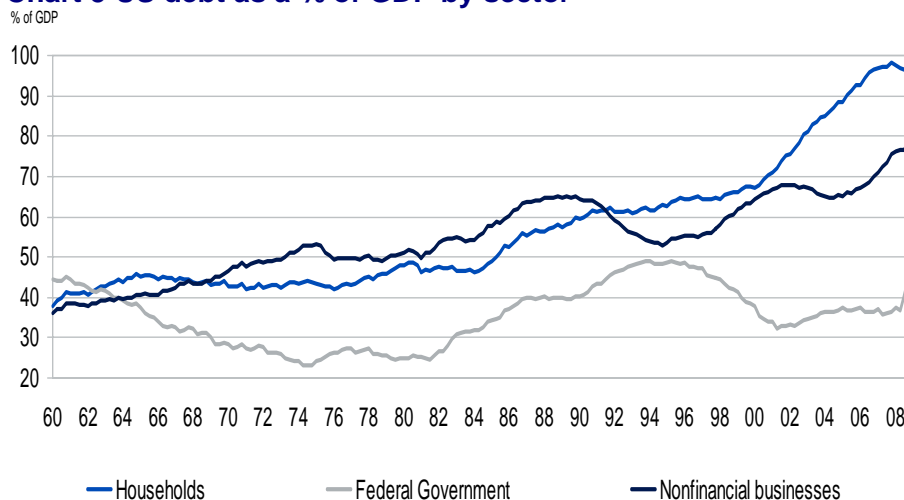
This is the key difference between this recession and those of the past. In the 1970s, 80s and 90s the recession was a response to higher inflation. Once weaker activity and higher unemployment had beaten inflation, interest rates could be cut and growth revived as households went out and borrowed.

The problem this time is that lower interest rates have not generated stronger borrowing. The credit crunch has been largely responsible, but past experience of banking crisis in other economies shows that recovery is slow to come through as, notwithstanding the tendency of the banks to become more cautious as the economy weakens, the demand for credit takes time to revive.

And so it should. In the near term fear of unemployment will constrain any return to borrowing. More generally though the household sector has become overextended, borrowing on the back of over inflated house prices. Those house prices are still above their long run averages relative to incomes and need to adjust further (see Chart 11 in UK section below). So this recession is not like the inflation cycles of the past, but is a balance sheet recession where households need to adjust to lower house prices and incomes.

This puts talk of recovery and the efforts of policy makers in a rather different light. All they are doing is offsetting the headwind from de-leveraging, replacing private debt with public and not providing the basis for sustainable recovery.

Chart 5 US debt as a % of GDP by sector



Source: DataStream, Schroders, 20 April 2009

Bank of England Governor Mervyn King put it well in a recent speech when he said that – *“This is the paradox of policy at present – almost any policy measure which is desirable now appears diametrically opposite to the direction we need to go in the long term”*.

In other words encouraging consumers to borrow when they need to save. It is mainly for this reason that we are sceptical that Quantitative Easing (QE) will have much effect as the extra money is likely to build up in deposits and not be lent to the real economy.

We may well see better activity in the near term, but it is likely to falter as balance sheet de-leveraging slows demand. This is the main hurdle to equity market recovery and there will be further issues stemming from this which markets will have to deal with.

The risk of deflation

The first is deflation. An extended period of recession and weak recovery means unemployment will stay high. The output gap will weigh on prices and given that inflation is already low we could see the US and UK tip into deflation later in the year. There is a high probability of this outcome as inflation tends to lag the cycle so will be falling in response to the output weakness we have already experienced.

One reason in our opinion why central banks have been so quick in moving rates toward zero and adopting QE is fear of this outcome. They do not want deflation to become entrenched. Once prices start falling it becomes even harder to get people to borrow as real rates are rising and the burden of past debts are higher. There is also a tendency to delay spending today as goods will be cheaper tomorrow. Such was the Japan experience in the 1990s.

The recession will create significant deflationary pressure....

And cut into company profit margins

Profit squeeze

Although a global recession is largely discounted, markets do not seem entirely prepared for the scale of the likely squeeze on corporate earnings (EPS). Our top down profit model indicates that with profit margins under pressure the fall in EPS will be a multiple of the fall in GDP. So for the US, where GDP is forecast to contract just under 3% this year, operating earnings are forecast fall 18%. At the reported level the figures could be worse due to further write downs, but the real problem is that the profits slowdown is spreading from the financial to the non-financial sector (see the *March Viewpoint* for more on profits).

It is possible that the market will look through this and withstand PE ratios (of up to 100 times), but only if confidence in the recovery is firm. Investors can withstand high PE's if they believe earnings have troughed. So far the current earnings season has seen some high profile upside surprises from banks. However, elsewhere the picture has been more mixed with the consumer discretionary, materials, energy and industrials all recording a 25% or more fall in earnings estimates since the beginning of the quarter. Overall S&P500 earnings are expected to be down 35% once all companies have reported.

The gap between the IMF and US treasury on bank recapitalisation

Banking sector recapitalisation

There is still a need to recapitalise the US banking sector. We were surprised to hear initial reports that all 19 of the big banks in the US had passed the stress tests currently being carried out by the administration to determine their future capital needs. Although many have returned to profitability as a result of the wide margin between the cost of funds (close to zero) and lending rates (circa 4- 5%), the estimated level of losses would seem to far outweigh this.

For example, the IMF now estimate total losses at \$4.1 trillion while Bloomberg record only \$1.3 trillion as written off. Not all of the IMF estimate is for the US, some \$1.2 trillion is in Europe. Nonetheless, the IMF figures imply that US banks need between \$275 and \$500bn of equity. This seems at odds with statements from Treasury secretary Geithner that the vast majority of US banks are well capitalised. At the time of writing reports suggest that at least six of the 19 require more capital, indicating further turbulence in the markets following the public release of the stress test results on 4th May.

Conclusion

The green shoots of recovery are appearing and could continue to develop through the summer as the inventory cycle turns and the benefits of fiscal and monetary policy are felt. However, we do not see the stimulus as gaining traction through stronger multiplier and credit creation effects. The combination of a banking sector which wishes to conserve capital and a private sector which will be reluctant to borrow should mean that growth will fade again as winter approaches.

UK

From bad to worse

It appears that some of the downside risks for the UK are materialising in the form of ever worsening public finances and weaker economic growth prospects. There have been some positive signs that the recession will bottom out sooner rather than later, though the shape of the recovery and the aftermath will present difficult policy questions moving forward.

Borrowing to rise as growth downgraded...

As widely expected, Chancellor Alistair Darling downgraded his forecast for GDP growth in 2009 and 2010, and announced record levels of borrowing totalling £606bn over the next four financial years - £226bn more than his previous estimates. The implications of the fiscal package are stark and not only for gilts. Darling announced a fiscal stimulus of ½% of GDP for 2009, but an average of 0.8% annual fiscal consolidation until 2013/14.

Ricardian equivalence theory suggests that consumers internalise government borrowing plans into their behaviour in order to smooth consumption. On this basis, the effect of any fiscal stimulus in 2009 could be overshadowed by the need to fix the public finances. However, except for the already planned re-instatement of VAT at 17.5% in January and the rise in national insurance (NI) in 2011, the Chancellor has not announced any new tax increases for under £150,000-earners. Indeed, Darling announced some additional help for pensioners and low income families.

While it is impossible to ignore the political significance of the step change in the strategy to redistribute income, providing more help to low-earners, who have a higher marginal propensity to consume, could boost consumption and stimulate the economy more effectively. For our views on the Budget, (see [“UK Budget 2009: The return of Old Labour?”](#) for detailed coverage).

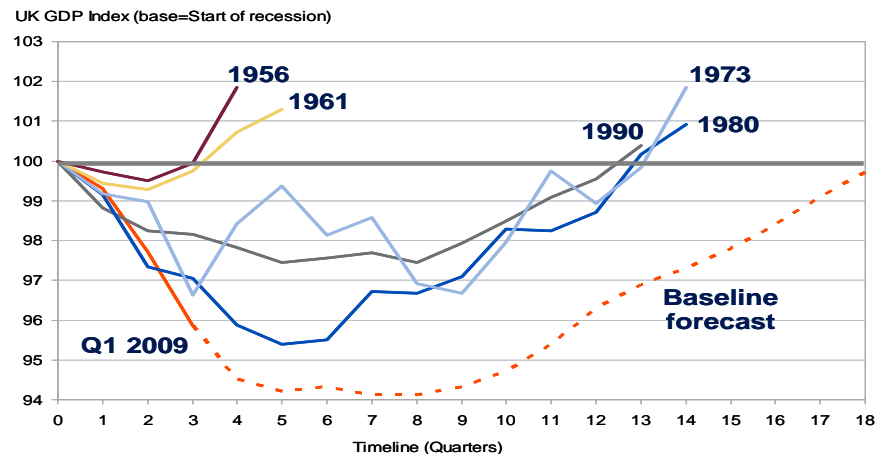
...but not downgraded enough...

Although Darling's GDP growth downgrade was more pessimistic than the current consensus forecast (April), the surprisingly weak Office of National Statistics' (ONS) preliminary estimate of -1.9% for first quarter GDP growth has already cast doubt on the Chancellor hitting his forecast.

We believe that the Chancellor's forecast is optimistic and have downgraded our baseline forecast for growth to -4.5% in 2009, and -0.5% in 2010.

Chart 6 illustrates our updated baseline recovery path. Our forecast implies the UK will experience the deepest and longest recession since the Second World War.

Chart 6: Comparison of previous recession paths



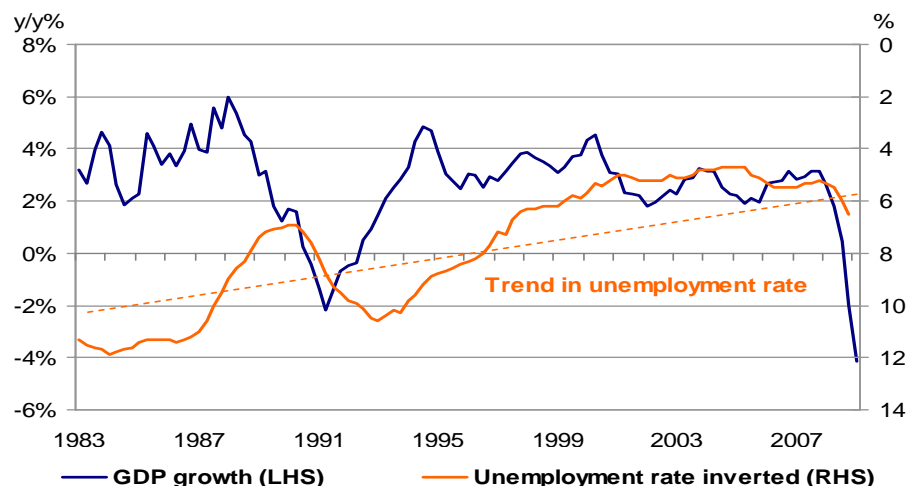
Source: Schroders, DataStream, 20 April 2009

We forecast the economy to continue to contract in the second and third quarters, albeit at a slower pace, as consumers continue to deleverage and businesses struggle to access credit. We expect the impact of automatic stabilisers to start feeding through by the end of the year and coupled with the re-instatement of VAT at 17.5% in January, we have a temporary consumption-led pick up in growth as consumers are incentivised to bring forward spending into the fourth quarter, with the first and potentially second quarters of 2010 suffering as a result.

...putting pressure on jobs and wages...

ONS Labour market statistics published in April showed a rise in unemployment of 177,000 in the three months to February, taking the total unemployed to 2.1 million, and the rate of unemployment to 6.7%. Yet as shown in Chart 7, unemployment still has some way to rise (inverted right-hand scale) to catch-up with the falls in output, despite the early shedding of labour by firms.

Chart 7: GDP growth vs. unemployment rate



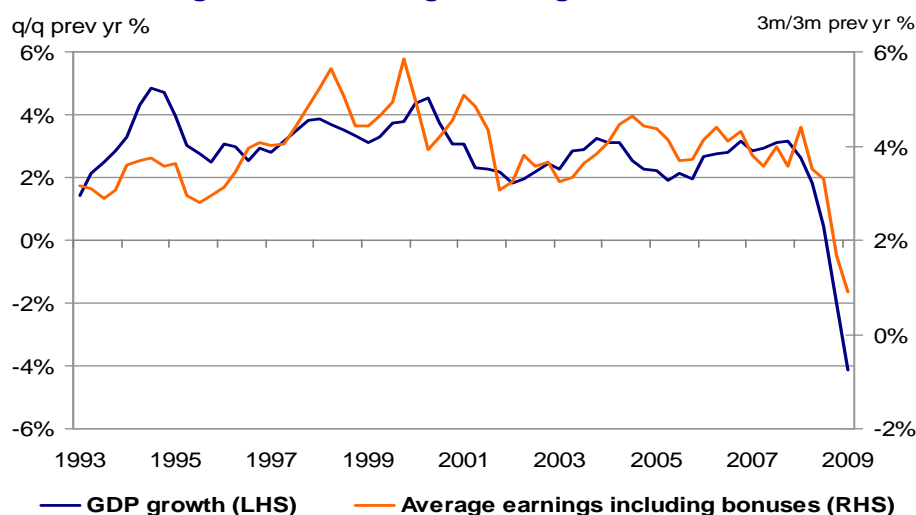
Source: Office of National Statistics, Datastream.

The falling trend in the unemployment rate caused mainly by increased immigration (and to a certain extent by the re-classification of students and disabled people) is unsustainable. The introduction of restrictions on migrants from outside the European Union means that the UK will struggle to fill the void of Eastern European migrants heading home having seen the value of their sterling wages fall by over 20%.

More alarming has been the collapse in average earnings including bonuses in February which fell by 2.1% on the month and increased by just 0.1% on a 3-months on 3-months a year earlier basis (against a consensus of 1.4%). As the impact on City bonus begins to be recorded, the ONS estimates that average earnings including bonuses in private services sectors are down by over 4% compared to February 2008. It is little surprise then that the preliminary estimate for output in the business services and finance sector contracted by 3.4% over the same period (published in the Index of Services).

Chart 8 shows the close relationship between earnings and GDP, mainly due to the measure (along with employment and average hours) being used by the ONS to calculate service sector output.

Chart 8: GDP growth vs. average earnings incl. bonuses



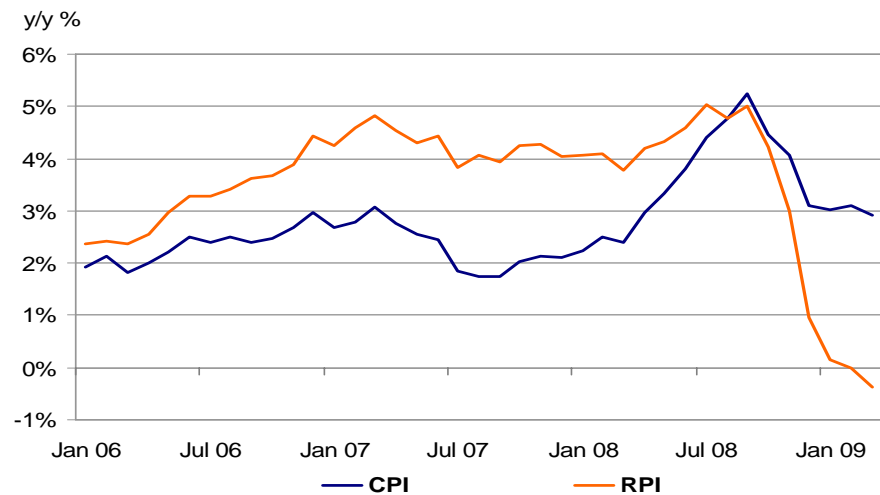
Source: Office of National Statistics, Datastream.

...and increasing deflationary pressures.

We expect continued weakness in earnings and rising unemployment to exhume deflationary pressures over 2009 and 2010.

The Retail Price Index (RPI) showed an annual fall in prices by -0.4 in March – the first annual decline in the index since 1960. Downward pressure from the ongoing correction in the housing market has opened up a troubling wedge between the RPI and the government’s official measure the consumer price index (CPI); see Chart 9. Should the wedge remain, and we expect it to, the government will face the challenge of downward pressure on private sector wages with public sector cost pressures continuing to rise.

Chart 9: CPI and RPI inflation



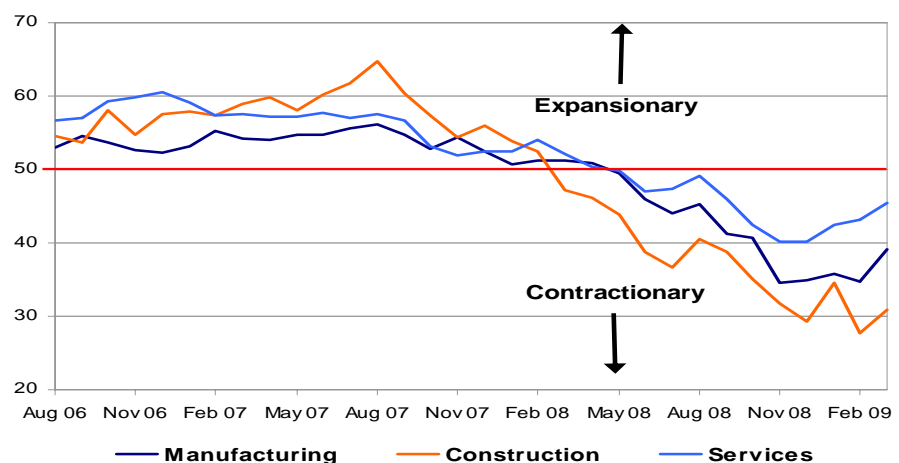
Source: Office of National Statistics, Datastream.

In line with our GDP forecast, we expect the VAT increase to lift both indices for the first quarter of 2010, before settling to low month on month increases supported by a sluggish return to growth.

Soft turning point?

Despite all the bad news this month, there were encouraging signs from soft data in the form of house price surveys and private business surveys. The Confederation of British Industry's (CBI) Monthly Retail Sales survey for April reported a monthly rise and the best sales since January 2008. Meanwhile, the CBI's Industrial Trends survey indicated a significantly softer contraction in manufacturing output (best reading since October 2008). This signal was supported by the three CIPS/Markit PMIs which all reported a rise in output in March (see Chart 10).

Chart 10: Purchasing Manager's Indices

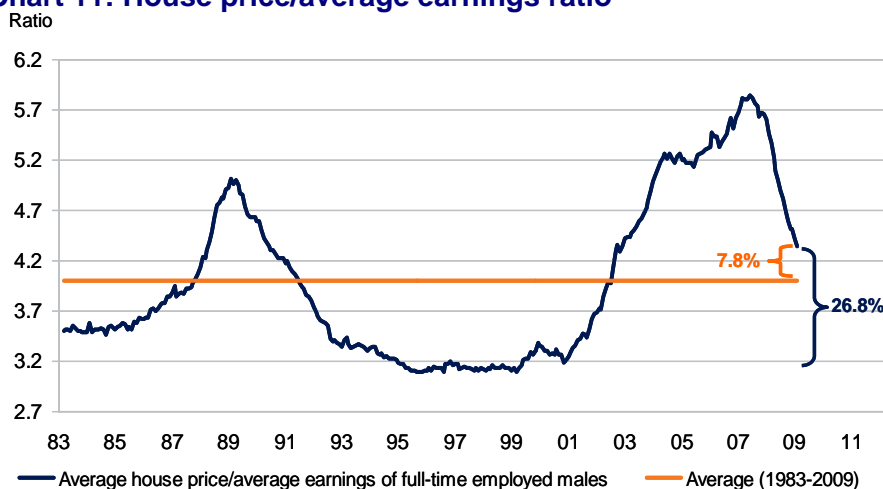


Source: CIPS/Markit, Bloomberg.

It is difficult to say whether this is the bottom of the recession or whether this is a 'dead cat bounce'. The Services PMI in particular looks much more healthy than the end of 2008.

A similar story is developing with the house-price surveys. Following the Nationwide survey's unexpected rise in March and similar positive reports from the Hometrack and RICS surveys, optimism seems to be returning to the housing market. However, we believe that the housing market correction is far from over. The British Bankers Association reported the number of loans approved for house purchases in March fell to 26,097, from April's level of 28,024. This remains very low compared with peaks of close to 90,000 approvals in 2003. As Chart 11 shows, UK house prices still have some way to fall relative to average earnings before they can begin to grow again.

Chart 11: House price/average earnings ratio



Source: HBOS, Schroders, 20 April 2009

Ratio of the Halifax standardised average price to national average earnings for full-time male employees. Price Earnings ratios revised to reflect new data in the Annual Survey of Hours and Earnings (ASHE). Latest value is Halifax estimates. Note that February and March no. is Halifax estimate.

Forecast Summary

I. Forecast summary - Schroders

Real GDP

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	1.1	-2.8	-2.7	0.6	1.8
UK	5.8	0.7	-4.5	-3.3	-0.5	0.3
Eurozone	25.5	0.8	-2.5	-3.4	0.7	0.3
Japan	9.2	-0.9	-4.5	-6.3	0.8	0.8
Australia	1.9	2.5	-0.5	-0.6	1.5	1.7
OECD	71.4	0.7	-3.0	-3.4	0.6	1.0
China	7.1	9.0	6.5	7.0	7.5	8.3
Emerging*	28.6	6.3	1.6	1.1	3.9	4.3
World	100.0	2.3	-1.7	-2.1	1.5	1.9

Inflation CPI

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	3.8	-0.6	-0.7	0.4	1.6
UK	5.8	3.6	1.6	1.4	1.4	1.7
Eurozone	25.5	3.3	0.5	0.4	0.5	1.3
Japan	9.2	1.7	-1.0	-1.3	-0.2	-0.5
Australia	1.9	4.5	2.0	2.1	1.8	2.4
OECD	71.4	3.3	0.0	-0.1	0.5	1.3
China	7.1	5.9	3.0	-0.1	4.0	1.6
Emerging*	28.6	7.9	2.6	4.4	3.0	4.6
World	100.0	4.7	0.7	1.2	1.2	2.2

* 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	1.00	1.79	1.00	2.51
Japan	9.2	0.10	0.10	0.53	0.10	0.71
OECD	69.5	1.52	0.53	1.54	0.53	2.25

Market from forward futures strip as at

26/02/2009

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

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Key changes to UK baseline forecast:

- Downgrades to growth in 2009 and 2010 following the weaker than expected Q1 preliminary estimate of -1.9, and higher than expected fiscal consolidation from the 2010/2011 financial year.
- An upward revision to the CPI inflation forecast for 2009 following slightly stickier outturn numbers than predicted.
- We do not expect the Bank of England to raise its policy rate until there are signs that the momentum in growth gains some traction.

Changes to UK baseline forecast	Forecast		
	2008	2009	2010
GDP Growth (%)	0.7	-4.5 (-3.0)	-0.5 (-0.5)
CPI inflation (yr average %)	4	1.6 (1.0)	1.4
RPI inflation (yr average %)	2.7	-1.3	1.7
BoE policy rate (Dec %)	0.5	0.5	0.5

Source: Schroders

Numbers in brackets represent previous forecast.

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 A: GDP consensus forecasts

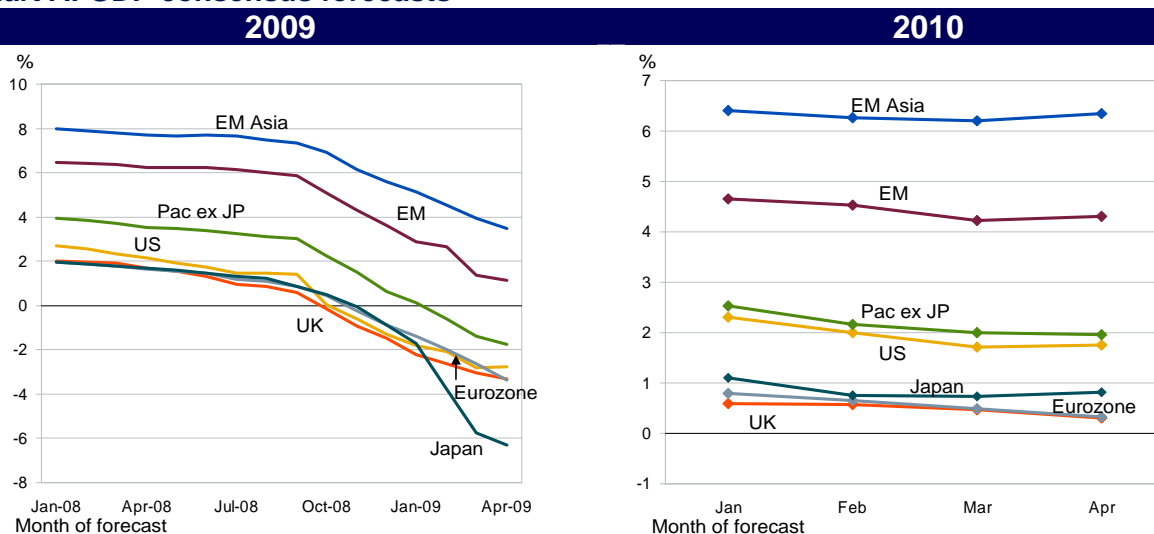
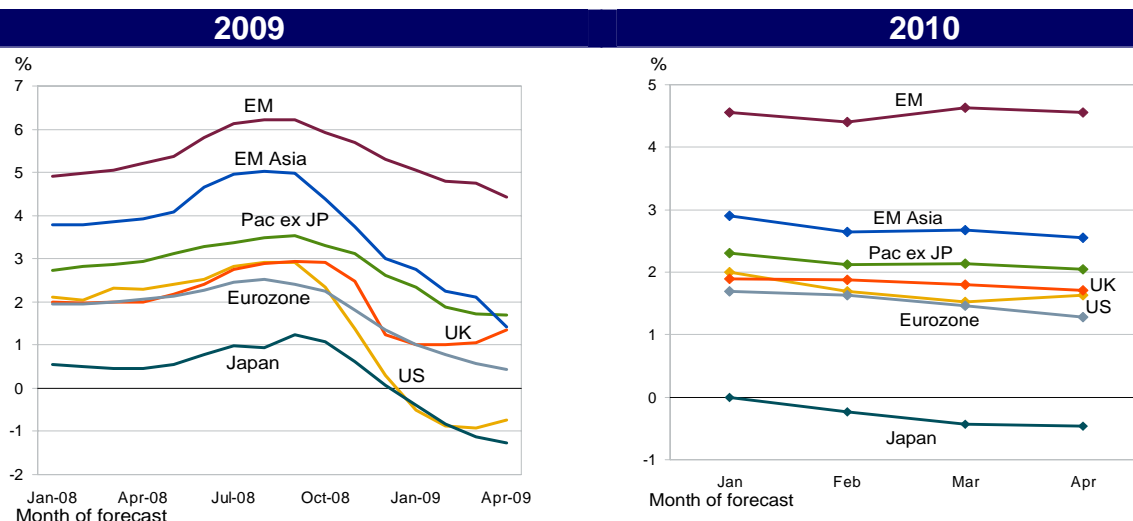


Chart B: Inflation consensus forecasts



Source: Consensus Economics (April 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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