

Schroders

Economic and Strategy Viewpoint

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Global: Is the recession ending? (page 2)

- The first phase of the recession where activity falls off a cliff is nearing a close, as firms adjust to lower levels of output. This is apparent in business surveys, which indicate a turn in the inventory cycle and the continuing thaw in the financial markets.
- Quantitative easing (QE) may be playing a role in this by adding to institutions holdings of cash, which they can then use to fund new issues of equity and credit. Effectively the Bank of England and the Federal Reserve are channelling new funds to the corporate sector, via institutional investors, thereby dis-intermediating the banks in the process.
- Whilst all this might herald an imminent recovery, in reality, the economy is likely to experience a phase of bouncing along the bottom where activity effectively goes sideways. The length of this period then depends on the speed with which the economy can overcome the forces, which drove it into recession in the first place.
- As we have highlighted before, the evidence from past financial crises indicates that the need for a period of balance sheet repair means that recovery tends to be slow to come through. Given the global nature of today's crisis we do not see why it should be different this time. The first phase of the recession may be ending, but we could be bouncing along the bottom for some time.

Eurozone: Can the union recover? (page 5)

- A gloomy month for the eurozone as Q1 is confirmed as the worse quarterly performance since the formation of the union. First quarter growth disappointed at -2.5% Q/Q, with export dependent economies, particularly Germany, suffering most. On the back of the paltry start to the year, we have revised down our growth forecast to -5.5% in 2009, and -0.3% in 2010.
- We expect weak international demand and further destocking to hold back any sustained recovery until 2010, keeping inflation subdued over the forecast horizon. Furthermore, the need for large destocking and the sharp falls in manufacturing output are expected to cause unemployment rates to soar.
- The impact on public finances will be considerable and despite the UK being singled out by Standard & Poor's this month, we expect government debt to rise substantially across the eurozone, with more agency downgrades following suit.

Forecast update

- We have updated our global growth forecast to reflect the weaker than expected first quarter. As a result, the loss of output in 2009 is now greater than previously expected at -3% (-1.5%). We still look for a subdued recovery with the growth profile improving throughout the year, inflation and interest rates are expected to stay low (see page 12 for details).



Global

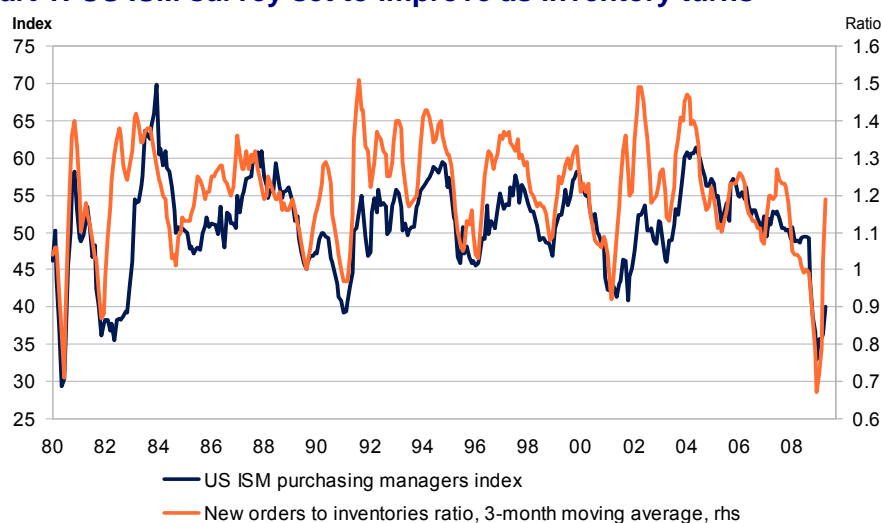
Is the recession ending?

Approaching a turning point

Although confidence in the economic recovery may have faltered a little over the past month, it is still likely that we are near a trough in economic activity. Evidence from business surveys and trade figures suggests that we are close to a turning point. In our opinion, all should continue to improve, or fall less rapidly and it is likely that the second quarter will mark some sort of trough, or at least an end to the first phase of the recession.

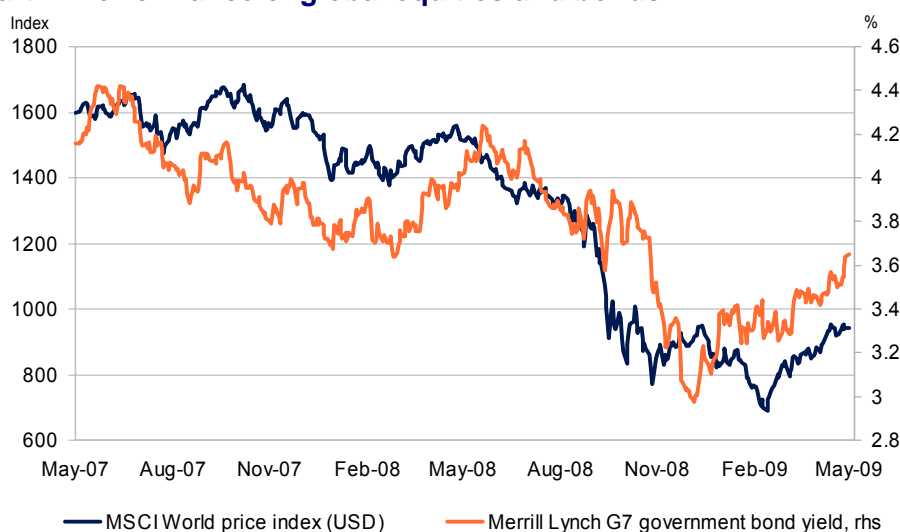
The period where activity drops like a stone as businesses adjust their output and the size of their workforce to a lower level of sales is drawing to a close. Such episodes typically last four or five quarters as companies attempt to gauge the sustainable level of demand and we are now a year to 18 months into the recession (depending on which economy you choose). Significantly, business surveys indicate that companies have a better balance between orders and inventories. Purchasing Managers indices around the world have been improving and the ISM index in the US is soon likely to rise back above 50, the threshold between expansion and contraction (chart 1).

Chart 1: US ISM survey set to improve as inventory turns



Source: Thomson Datastream, 22 May 2009

The view that we are close to stability is reinforced by improvements in financial markets with equities and credit rallying and government bond yields moving up (chart 2 on next page). Volatility, as measured by the VIX index, has fallen significantly, an indication that investors are prepared to accept less to insure portfolios.

Chart 2: Performance of global equities and bonds

Source: Thomson Datastream, 26 May 2009

***Credit arteries
beginning to clear,
helped by QE***

The revival in financial markets is important from a macro perspective as it indicates that the credit arteries are beginning to flow again. Certainly, bank lending remains subdued and lending surveys indicate that conditions are still tight. Nonetheless, companies are able to raise finance either through credit or rights issues with a surge in capital raising activity underway. In some cases this will have been helped by quantitative easing as institutional investors in the US and the UK find that their holdings of cash are even more overweight than before following sales of government bonds to the Bank of England or Federal Reserve.

Bouncing along the bottom

***A new phase in the
recession***

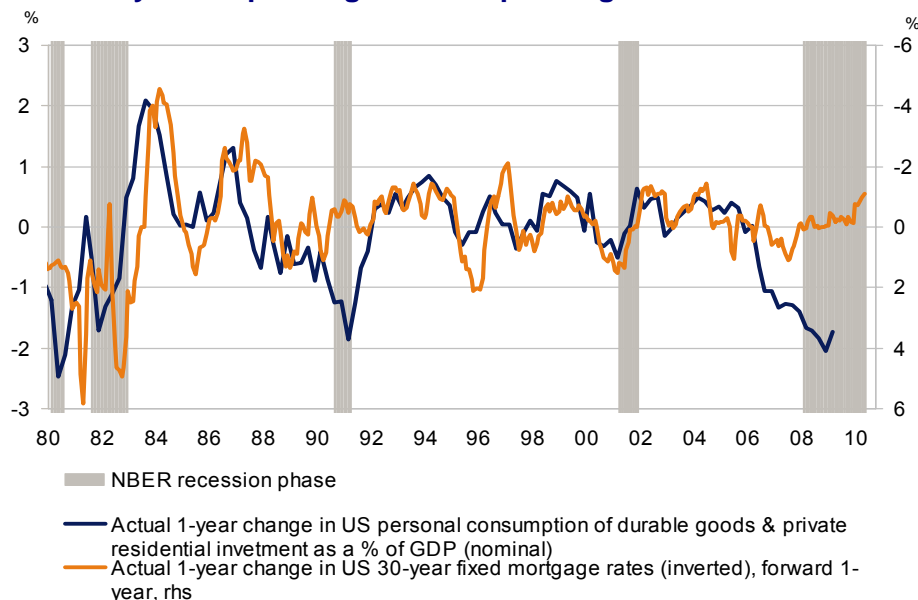
Although, some would argue that these developments mean that the recession is nearly over in the US, this suggests that we are moving into the next phase, one which can be described as “bouncing along the bottom”. During this period, output effectively goes sideways as the economy attempts to build a base from which it can start to grow again. It is characterised by periods of false hope as a quarter or two of improvement is often followed by a set back.

The length of this stage largely depends on the speed with which the economy can overcome the forces which drove it into recession in the first place. In the recent past, inflation has been the trigger for recession and once prices have come back under control, activity has been able to rebound robustly as businesses and households re-leverage in response to easier monetary policy.

Unfortunately such a classic V-shape is unlikely this time as the problem of over leverage indicates a lengthy period of balance sheet repair. Studies of past financial crises confirm that recovery is far slower and more subdued than in other cycles. So far, the interest rate sensitive components of the economy – durable goods and housing - have simply not responded to the fall in interest rates (chart 3 on next page), an indication that this recovery will be weak and similar to others that have followed a financial crisis.

In some respects, the UK recession of the early 1990s shared some of these characteristics as households struggled with negative equity following the bursting of the housing market bubble of the 1980s. The subsequent bouncing along the bottom phase lasted nearly a year.

Chart 3: Cyclical spending is not responding to lower rates



Source: Thomson Datastream, NBER (National Bureau of Economic Research, Schrodgers, 26 May 2009

Combine this with the fact that this time the world economy remains in the doldrums so there is less likelihood of an export led recovery and it is likely to be some time before we see signs of a sustainable recovery. During this period, growth is unlikely to be strong enough to prevent unemployment from continuing to rise and consequently it will feel as though we are still in recession. The first phase of the recession may be ending, but we could be bouncing along the bottom for some time.

Eurozone

Challenging times

With both presidential and parliamentary elections in Germany this year and Italian and French parliamentary elections next, European leaders are keen to show they are supporting their economies while maintaining fiscal discipline. However, given the current economic data, this may now be more challenging than would have been perceived during the G20 summit, where fiscal hardliners clashed with those encouraging a braver policy response.

Terrible start to 2009...

First quarter flash estimates for the eurozone highlighted the savage adjustment taking place across the monetary union. Table 1 shows the latest estimates for the eurozone with first quarter growth estimates disappointing: -2.5% against the Bloomberg consensus of -2.0%. Inflation also remained subdued in April as year on year eurozone inflation was unchanged at 0.6%.

Table 1: Recently published Q/Q% GDP growth *

	Aus	Bel	Cyp	Fra	Ger	Ita	Neth	Por	Slo	Spa	EA16
08Q3	0.0	0.0	0.4	-0.2	-0.5	-0.8	-0.5	-0.4	1.8	-0.3	-0.2
08Q4	-0.4	-1.7	0.5	-1.5	-2.2	-2.1	-1.2	-1.9	2.1	-1.0	-1.6
09Q1	-2.8	-1.6	0.0	-1.2	-3.8	-2.4	-2.8	-1.5	-11.2	-1.9	-2.5

Source: Eurostat, 25 May 2009

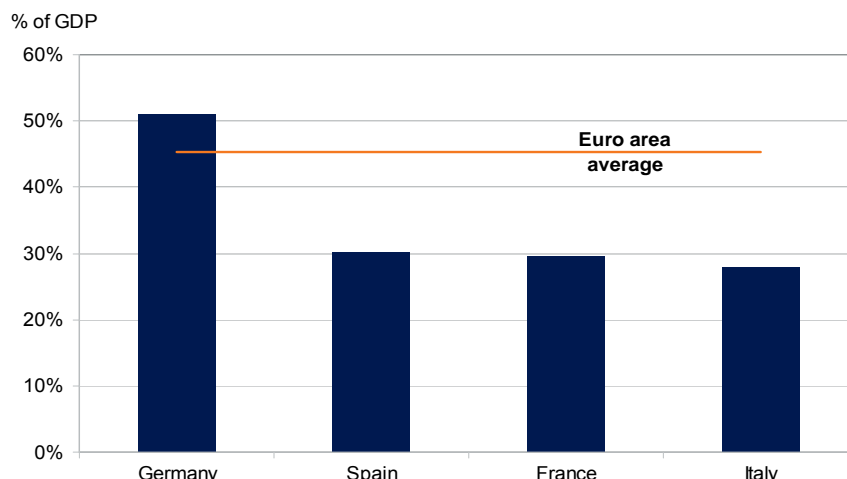
* Excluding members that have not yet published Q1 estimates

Every reporting member state with the exception of Cyprus contracted in the first quarter, though GDP for France, Belgium and Portugal contracted at a slower rate than the fourth quarter. As these are only provisional estimates, it is important to take these with a pinch of salt. For example, France has revised down its Q4 growth estimate from -1.1% to -1.5%. In addition, Spain has already revised down its Q1 estimate by another 0.1 percentage point since the 15 May Eurostat release. Also, earlier quarters are not revised in flash estimates, so there may be further revisions to the profile of the downturn.

...as exporters are hit the hardest.

Globally, export dependent countries have been particularly affected by the slowdown in world demand, with eurozone members no different. The largest GDP contraction amongst the big four was in Germany with exports down 9.7% Q/Q. As chart 4 on the next page illustrates, Germany is far more reliant on export demand than France, Italy or Spain and will need global trade to rebound before a sustained recovery can begin.

Chart 4: Exports as a percentage of GDP



Source: Eurostat, 25 May 2009.

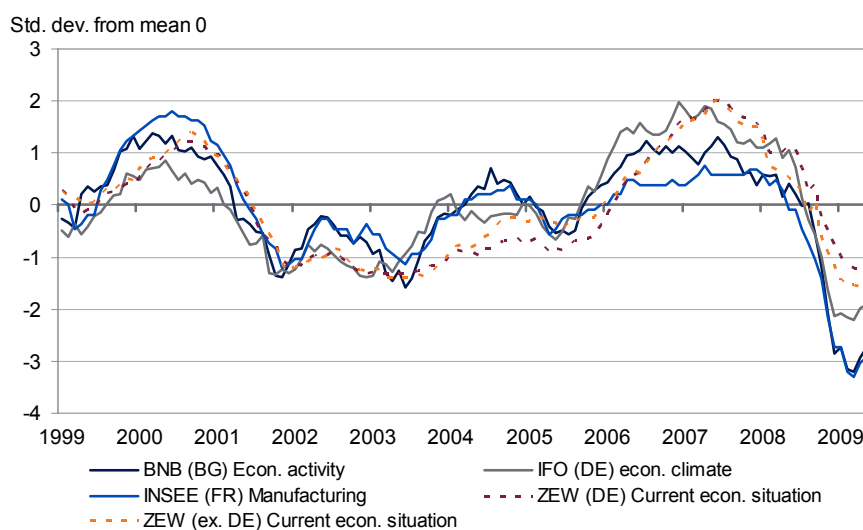
Is there a recovery in 2010?

At the end of last month, Economy Minister Karl-Theodor zu Guttenberg announced that he had revised down his 2009 annual growth forecast from -2¼% to -6%. Guttenberg does however expect a modest recovery (½%) for 2010 as the effects from the fiscal stimulus plan gain traction.

Organisations such as the OECD (Organisation for Economic Co-operation and Development), European Commission and European Central Bank have forecast a eurozone recovery only in 2010. However, ECB vice-president Lucas Papademos argued recently that a recovery “may start sooner than previously envisaged”. Certainly forward-looking economic sentiment surveys such as the German based ZEW survey, the IFO and Markit PMIs are all signalling a clear turning point in the coming months.

While optimism is growing across the eurozone, surveys that measure current economic conditions have only just started to reflect less negative activity (chart 5).

Chart 5: Current economic situation indicators



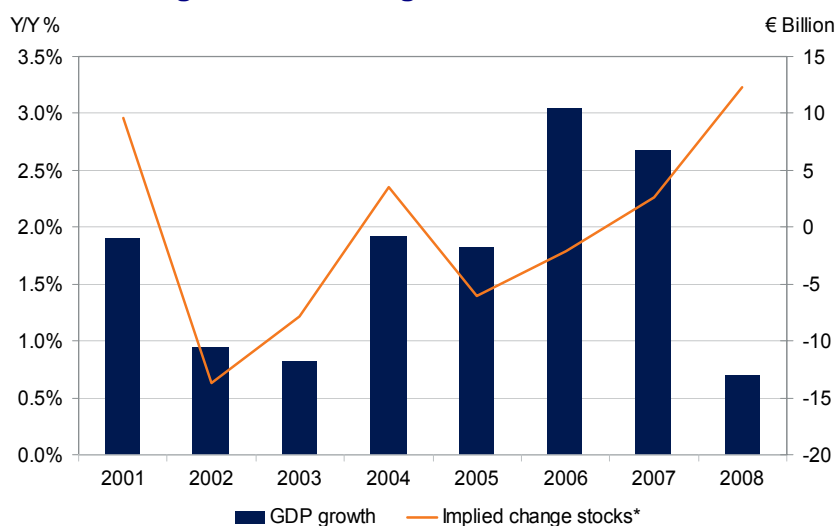
Source: Eurostat, Datastream, BNB, INSEE, IFO, ZEW, 27 May 2009.

We agree that the worst of the quarterly contractions are behind us now but cannot see a significant recovery until consumption begins to improve in the US and UK. In addition, evidence suggests that the destocking cycle has only just begun.

More destocking ahead?

Chart 6 (the relationship between the level of inventories and GDP growth) shows that the eurozone as a whole has accumulated very large levels of stocks from 2008. Assuming 2007 was near equilibrium, we approximate that inventories need to be reduced in real terms by €24 billion, which translates to a mammoth 3.1% of GDP overhang. This is just to clear 2008 levels, and does not consider the need to adjust for the 2009 contraction in GDP. Given the tendency for destocking to overshoot and taking our 2009 forecast of -5.5% growth, we estimate the level of destocking to reach €30 billion, or 3.9% of GDP.

Chart 6: GDP growth vs. change in stocks



Source: Eurostat, 25 May 2009.

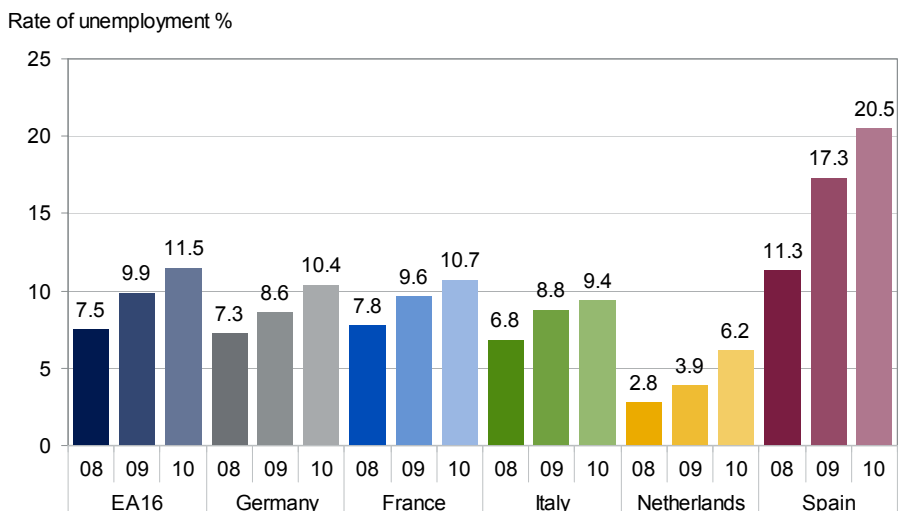
*Implied change in stocks derived from the difference in chain-linked gross capital formations and gross fixed capital formation.

The overhang hangover

With a huge overhang of stocks as well as falling domestic and external demand, manufacturers will be forced to reduce output drastically. Indeed manufacturing output in the big four fell off a cliff in the year to March: Germany -22.8%, France -17.7%, Spain -29.9%, Italy -25.1% (index of production). The UK's 12.9% fall looks small by comparison.

As factories close their gates, not even the threat of hostage taking of factory bosses in France can stop the alarming rise in unemployment. The European Commission forecasts eurozone unemployment to reach 11.5% by 2010, with the largest relative increases amongst the biggest members seen in the Netherlands and Spain (chart 7 on next page).

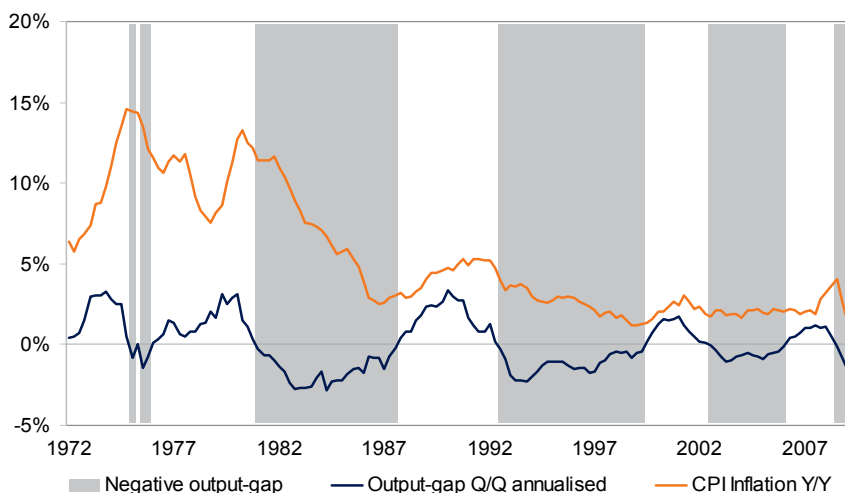
Chart 7: Forecasts of unemployment rates



Source: European Commission Spring 2009 Forecast

The combination of rising unemployment, weak domestic demand and a growing negative output-gap, will ensure inflationary pressures remain subdued for some time. Chart 8 illustrates how during periods where the level of GDP is below potential (negative output-gap), inflation tends to fall. This does not necessarily lead to deflation and our central forecast does not foresee sustained deflation taking hold. We forecast eurozone CPI inflation to average 0.7% over 2009 and fall to 0.5% over 2010. However, as Eurozone inflation is now starting from a low base, our more negative forecast scenario does feature continued deflation for 2009 and 2010.

Chart 8: European output-gap vs. inflation



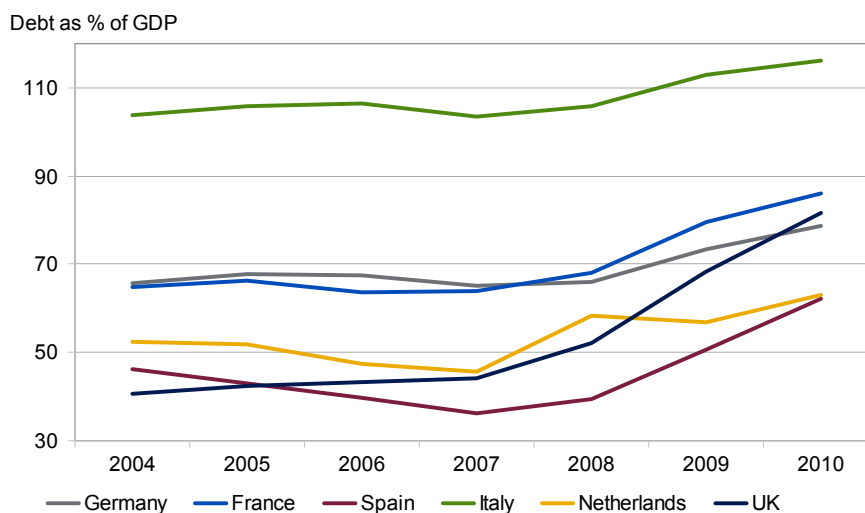
Source: OECD, Thomson Datastream, 25 May 2009.

Government debt to rise, but any better than UK?

Rising unemployment will inevitably lead to rising fiscal deficits and increased government borrowing over the forecast horizon. Standard & Poor's recently re-affirmed the UK's short and long-term debt ratings but downgraded its outlook rating from stable to negative. However, is government borrowing in the UK any worse compared to its European counterparts?

The European Commission forecasts the UK to overtake the Netherlands and Germany over the next two years as government borrowing rises across Europe (chart 9). Italy is one of the worst offenders with its borrowing expected to balloon to 116% of GDP, though Spain has a similar profile to the UK, albeit from a lower base.

Chart 9: Forecasts of government debt-GDP ratios



Source: European Commission Spring 2009 Forecast

Arguably, though the UK is likely to see the largest increase as a percentage of GDP, it is rising from a lower level. The UK is still below the 60% of GDP Maastricht Treaty level unlike Germany, France and Italy. However, the damage done to the UK tax base in the form of the impact of the credit crunch on UK financial services, and the falls in house prices mean that the UK is particularly at risk of debt reaching unsustainable levels. Nevertheless, the current S&P outlook ratings do not yet reflect the forthcoming deterioration in European public finances (Table 2).

Table 2: S&P Sovereign Credit Rating

Country	Outlook	Short Term	Long Term
UK	Negative	A-1	AAA
Germany	Stable	A -1+	AAA
France	Stable	A -1+	AAA
Netherlands	Stable	A -1+	AAA
Italy	Stable	A -1+	A+
Spain	Stable	A -1+	AA+
Ireland	Negative	A -1+	AA+
Portugal	Stable	A -1	A+
Greece	Stable	A - 2	A-

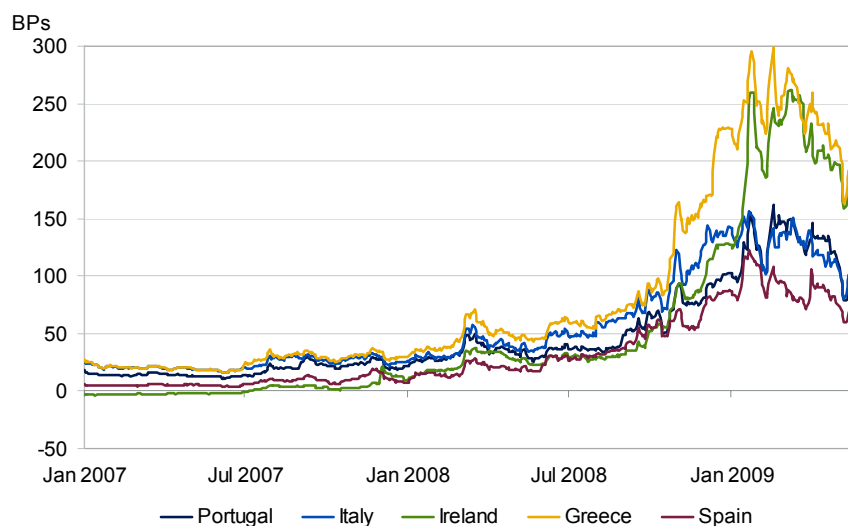
Source: S&P, Bloomberg, 25 May 2009.

We expect outlook ratings to be downgraded for Spain, France and Italy as the prospects for public finances worsen - though the risk of others being downgraded is high.

Reduced risk of union break up

Spiralling government debt has raised concerns over whether the monetary union could continue with all of its current members. Italy and Spain have long been favourites to abscond first, but more recently, Ireland, Portugal and Greece have joined the club. While the risks of a break-up were slim to begin with, markets now seem to be discounting a lower likelihood of this occurring. As Chart 10 shows, 10-year government yields over Bunds (the sentiments towards credit worthiness relative to Germany) for these countries have tightened substantially since fears of another great depression dissipated.

Chart 10: 10-year generic yields/Bunds spreads



Source: Thomson Datastream, 25 May 2009.

Eurozone Forecast Summary

Key changes (Table 3 & Chart 11 on next page):

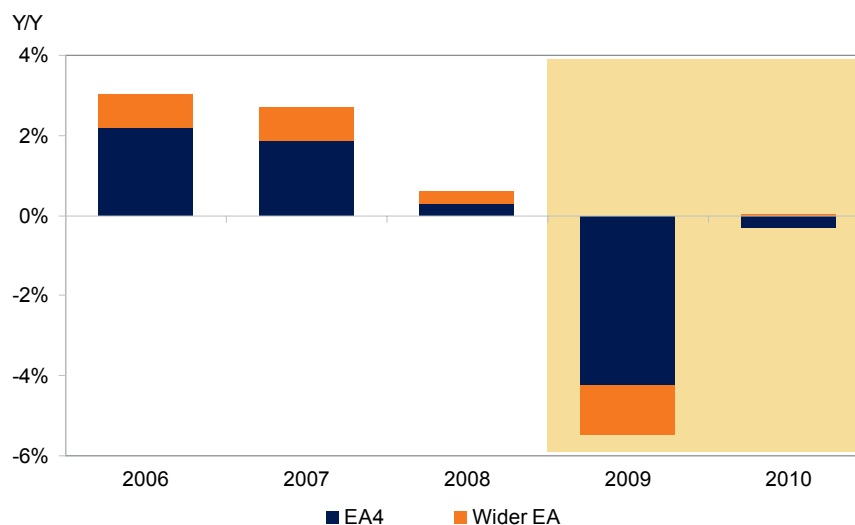
- Downgrades to growth in 2009 and 2010 following the weaker than expected Q1 preliminary estimate of -2.5. The big four are expected to make a total negative contribution to 2010 growth as smaller members lead bounce back quicker, albeit from a lower base.
- An upward revision to the CPI inflation forecast for 2009 following slightly stickier outturn numbers than predicted and rising energy prices.
- A downward revision to the CPI inflation forecast for 2010 as a significant output gap remains which is expected to keep wage growth subdued.
- We do not expect the ECB to raise policy rates until positive GDP growth returns and gathers momentum. However, we are forecasting a 25 basis point rise in the final quarter of 2010.

	2008		Forecast	
	2008	2009	2010	2010
GDP Growth (%)	0.7	-5.5 (-2.5)	-0.3 (0.7)	
CPI inflation (yr average %)	3.3	0.7 (0.5)	0.5 (1.0)	
ECB policy rate (Dec %)	2.50	1.00 (0.50)	1.25 (0.50)	

Source: Eurostat, Schroders

Numbers in brackets represent previous forecast.

Chart 11: Contributions to eurozone GDP growth forecast



Source: Eurostat, Schroders, 27 May 2009.

Forecast Summary

I. Forecast summary - Schroders

Real GDP						
y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	1.1	-3.1	-2.9	0.8	1.8
UK	5.8	0.7	-4.5	-3.8	-0.5	0.3
Eurozone	25.5	0.7	-5.5	-3.7	-0.3	0.3
Japan	9.2	-0.7	-6.5	-6.1	1.0	1.3
Australia	1.9	2.5	-1.0	-0.7	1.5	1.5
OECD	71.4	0.7	-4.4	-3.6	0.4	1.1
China	7.1	9.0	7.0	7.5	7.5	8.4
Emerging*	28.6	6.3	0.8	0.5	3.6	4.2
World	100.0	2.3	-3.0	-2.4	1.3	2.0

Inflation CPI						
y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	3.8	0.0	-0.8	1.2	1.6
UK	5.8	3.6	1.6	1.6	1.5	1.7
Eurozone	25.5	3.3	0.7	0.4	0.5	1.2
Japan	9.2	1.7	-1.5	-1.2	-0.6	-0.6
Australia	1.9	4.5	1.8	1.7	1.5	2.3
OECD	71.4	3.3	0.2	-0.2	0.7	1.2
China	7.1	5.9	3.0	-0.1	4.0	1.6
Emerging*	28.6	7.9	2.8	4.2	3.3	4.5
World	100.0	4.7	1.0	1.1	1.5	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	0.90	0.75	1.92
UK	5.8	2.00	0.50	1.24	1.00	2.51
Eurozone	25.5	2.50	1.00	1.22	1.25	2.02
Japan	9.2	0.10	0.10	0.47	0.25	0.68
OECD	69.5	1.52	0.53	0.99	0.89	1.84

Market from forward futures strip as at

19/05/2009

Key variables						
FX	Current	Dec-08	Dec-09	y/y%	Dec-10	y/y%
USD/ GBP	1.55	1.49	1.55	4.3	1.40	-9.7
USD/ EUR	1.36	1.35	1.40	3.5	1.30	-7.1
JPY/ USD	96.0	91.1	90.0	-1.2	100.0	11.1
GBP/ EUR	0.88	0.91	0.90	-0.8	0.93	2.8
Brent crude	57.3	40.5	59.1	45.9	65.7	11.2
US output gap %GDP	-6.3	-4.1	-8.2		-8.7	
Unemploy. %	8.1	6.9	9.7		10.5	

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

Baseline - deep recession in 2009, sluggish upturn in 2010

Our forecasts for global growth have been cut further since the last CMF with the world economy now expected to contract by 3% this year. The downgrade has largely been driven by the sharper than expected fall in first quarter GDP with the biggest forecast reductions being made in Europe and Japan.

Forecasts for the emerging markets have also been cut in response to weaker trade, although China has bucked the trend with a marginal upgrade following evidence that fiscal policy is boosting growth.

We continue to look for a modest recovery in global activity as the inventory cycle turns upward and monetary and fiscal policy gain traction. By past standards though the recovery is subdued as we expect the credit multipliers to be muted by ongoing de-leveraging in the household sector.

Inflation is forecast to fall sharply in 2009 helped by lower commodity prices and the slack created by the downturn. In 2010, inflation moves up again as a result of higher energy prices however deflationary pressures persist and the US is expected to experience a decline in core prices (deflation) in the second half of 2010.

Interest rates are now expected to rise slightly as the central banks bring an end to the ultra-loose period of monetary policy. By historical standards though, rates stay very 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 -3.1% 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 3% in 2009 (consensus -2.3%) from 2.3% in 2008 and recover to 1.3% in 2010, below the consensus estimate of 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 2.8% for EM, taking global inflation to 1% (after nearly 5% in 2008). These forecasts are a tad higher than 3 months ago to reflect higher commodity prices.

- 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 are expected to leave rates at current levels until the end of the year with the Bank of England and the Fed continuing with quantitative easing. Towards the end of next year, we look for rates to edge higher as central banks end the period of ultra-loose policy. Nonetheless, the forecast of weak growth and low inflation means policy is still considered to be loose by historic standards.

Currency

- This is a fairly neutral scenario for currencies. In the near term, evidence of recovery is likely to weaken the USD against the majors. Thereafter though the USD is expected to strengthen as the recovery disappoints and investors return to safe haven trades.

- The GBP underperforms as markets focus on the fiscal position and political risk in the run up to a general election.

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

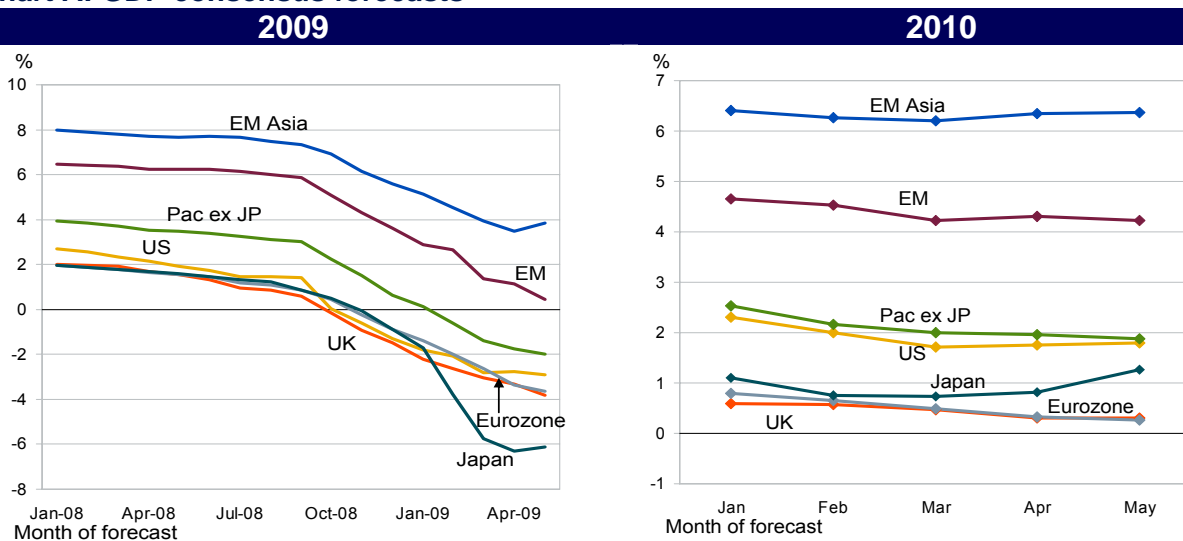
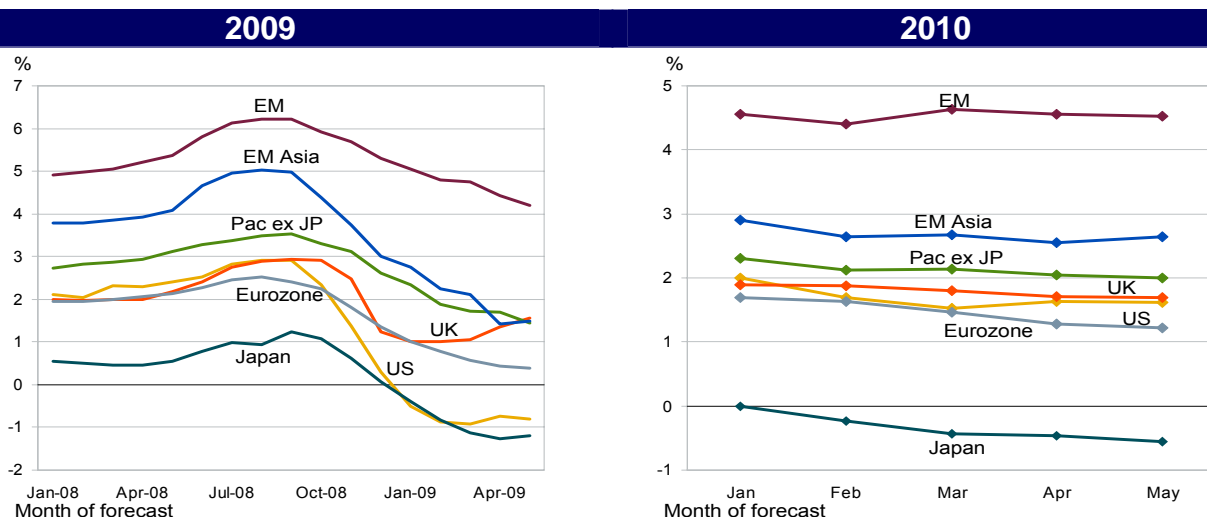


Chart B: Inflation consensus forecasts



Source: Consensus Economics (May 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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