

Schroders

Economic and Strategy Viewpoint

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Global: Central bank focus on the real economy creates bubble risk (page 2)

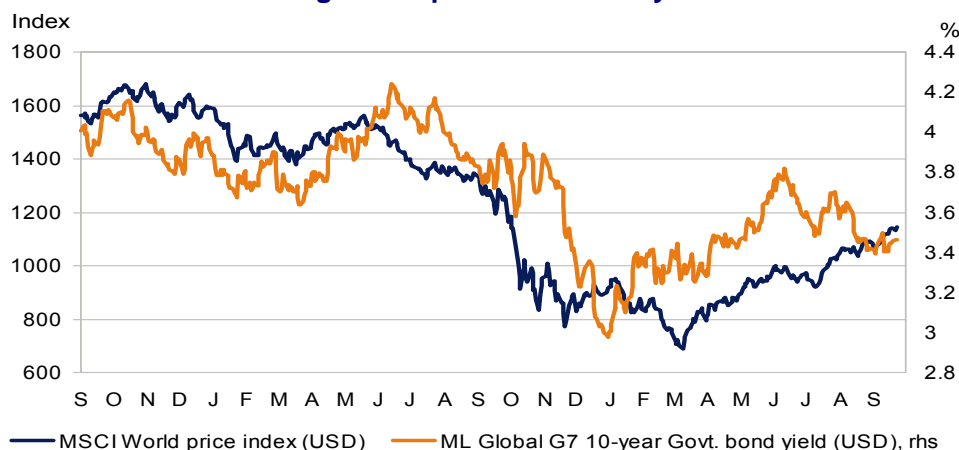
- Over the past three months, the rally in equity markets has been accompanied by falling government bond yields. This marks a contrast with the first phase of the recovery in markets where both equity prices and bond yields rose. The more recent performance of bond yields reflects the commitment of central banks to keeping interest rates low following a number of policy meetings and the G20 gathering of finance ministers. The authorities have been clear: it is too early to end easy money.
- From this perspective, the latest rise in investor risk appetite is an indication that liquidity is playing an increasing role in driving prices as investors move from cash into risky assets in search of return. Nonetheless, more fundamental support has been provided by the improvement in profitability, which we expect will be sustained as firms benefit from the operational leverage brought by a rising profit share.
- The risks lie on either side. The “W” shape recovery which forms our baseline view could cool risk assets as fears of a Japan style period of prolonged weakness return. Alternatively, there is the danger of a bubble in financial markets as zero interest rates force increasing numbers of investors out of cash. Such a risk is probably greatest in the emerging world which is in the vanguard of the recovery, but where monetary policy is generally tied to the US through the dollar.

UK: A national obsession (page 9)

- House prices are on the rise again as estate agents return to their old tricks of talking up the market. However, the importance of house prices to real household consumption cannot be underestimated. The recent rises are at odds with deteriorating labour market conditions and tighter bank lending, raising questions over their sustainability. Survey evidence points to a lack of supply of homes for sale while record low interest rates have made mortgages much more affordable, increasing demand for housing once again.
- However, there are signs that sellers are returning to the market, attracted by recent gains in prices. At the same time, the fundamentals have not improved. Unemployment is still rising, wages are under pressure, and a large bout of fiscal consolidation is about to follow.
- We believe house prices may continue to rise over the short-term, but will eventually resume the correction that began in 2007. This would lead the Bank of England to temper rises in its policy rate over the coming years in order to support household consumption.

Forecast summary (page 14)

Chart 1: Performance of global equities and bond yields



Source: Thomson Datastream, 23 September 09



Global

Both equity and government bond markets have rallied through the summer

Indicating a new phase of the bull market

Central bank focus on real economy creates bubble risk

From the trough in March, global equity markets have risen some 65% with the high beta emerging markets up 93%. Credit markets, which began to rally earlier, have continued to perform well with High Yield gaining more than 40% over the same period. The surge in risk assets has generally occurred against a backdrop of rising government bond yields. However, after peaking in June, G7 government bond yields have been on a declining trend, falling some 40 basis points (bps) to 3.4% in September (see chart 1 on front page).

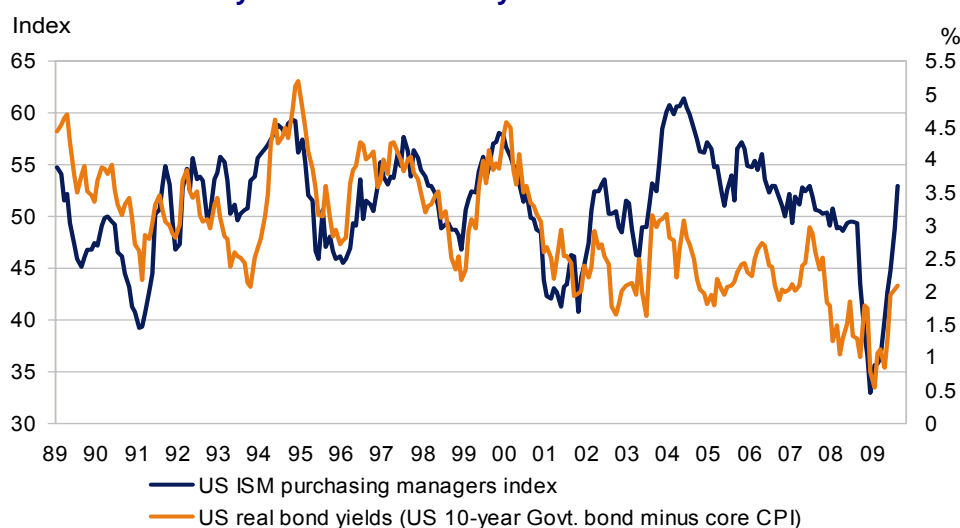
A two stage bull market

In this respect, the rise in equity markets since March can be categorised into two stages.

The first, between March and June, was one where both equities and government bond yields rose together. During this phase investors shrugged off the extreme risk aversion which had gripped markets through 2008 and into the first quarter of 2009. It was the “back from the brink” trade where investors realised that the prospect of another Great Depression - which markets had priced in - was more remote than popularly imagined given the enormous support being provided by the authorities. The first signs of a turn in activity indicators became apparent and this phase was also marked by the end of the forced selling which had hit markets in the wake of the earlier failure of Lehman Brothers.

The second stage, which began in June and has spanned most of the third quarter to date has been one where equities and credit have continued to rally while government bond yields have fallen. This is surprising in the sense that growth expectations have continued to improve with forecasts being revised upward, an outcome normally associated with rising bond yields. The correlation between the cycle and bond markets has not been as close in recent years, probably due to the Asian savings glut, nonetheless the recent surge in the ISM is consistent with higher real yields (chart 2).

Chart 2: ISM survey and US real bond yields



Source: Thomson Datastream, 23 September 09

Government bond markets have been underpinned by central banks and the yield curve

We would attribute the resilience of bond markets since June to the stance of the central banks and the steepness of the yield curve. The gap between short and long rates reached a 25-year high in June creating scope for long yields to decline (see chart 3).

Chart 3: US yield curve remains steep



Source: Thomson Datastream, 23 September 09

Central banks signal rates will stay low

Recent signals from the central banks indicate that they believe it is too early to remove policy support

Meanwhile, the central banks have underpinned the short end by confirming that policy will stay loose for a considerable period. This has been key to the performance of bonds as the authorities could have signalled a change in stance. Arguably, there is a case for unwinding some of the easing which was put in place after the Lehman collapse and near seizure of the banking system. The crisis has largely passed and with the improvement in growth expectations the case for policy support has weakened.

In the statement following the FOMC (Federal Open Market Committee) meeting of September 23rd, the Federal Reserve acknowledged that the economy had “picked up”, but noted the constraints on household spending and that businesses were still cutting back on investment and staffing, although at a slower pace.

As in August, the statement said that the committee “continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period”. However, the Fed did announce that it would end its planned purchases of Mortgage Backed securities by the end of March next year. Along with last month’s announcement to phase out Treasury bill purchases this suggests that although they believe rates should stay low, the FOMC do not see the need for further stimulus.

In the UK, by contrast the Bank of England surprised markets by announcing on August 6th an increase in its quantitative easing (QE) programme. The Bank will now buy an additional £50 billion of government and corporate debt over the next three months taking total purchases to £175 billion.

The Bank acknowledged that the economy was approaching a trough and that credit conditions were thawing, but following downward revisions to GDP also believed that the output gap and hence deflationary pressure had increased. Since it is the stock of assets purchased rather than the flow that determines the stimulus from QE, the decision to raise the stock could be seen as equivalent to a cut in interest rates.

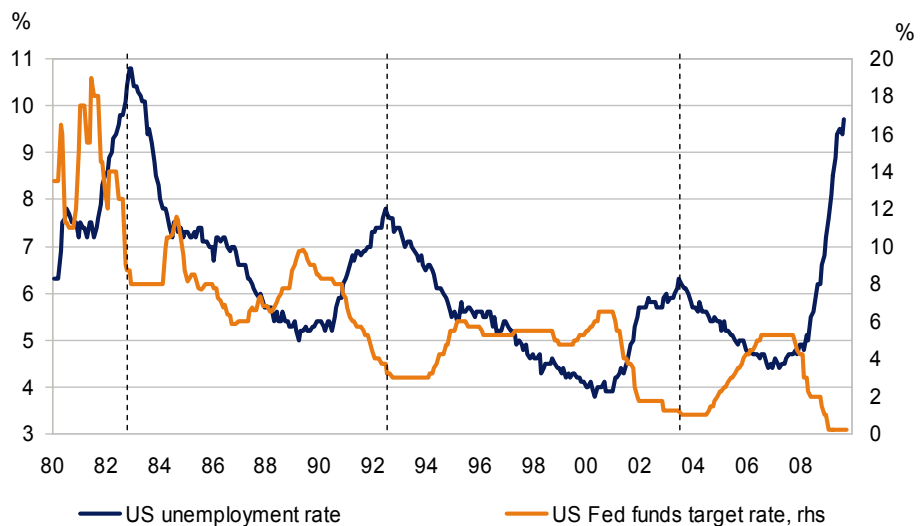
Too early for an exit from easy money

The Bank of England are probably at the dovish end of the spectrum on policy at present, however, along with the Fed, ECB (European Central Bank) and BoJ (Bank of Japan) all have signalled that it is too early to be embarking on an exit strategy from current policy settings. Writing in the Financial Times on 4th September Jean-Claude Trichet, President of the ECB spoke for many when he said *“Stressing the importance of the exit strategy should not be confused with its activation: it is premature to declare the financial crisis over. Today is not the time to exit”*.

In addition to doubts about the ability of the financial sector to function without official support, the case for maintaining policy is underpinned by concerns about the sustainability of the recovery (given the continuing weakness of final sales and credit growth), a benign outlook for inflation (given the size of the output gap) and fears of repeating the mistake of Japan in the 1990s by tightening too early.

Such caution is not unusual, as even in a normal cycle there is a considerable gap between the first signs of recovery and tightening. In the US, the unemployment rate has normally peaked and has been falling for some months before the Fed has begun to tighten (see chart 4). At present unemployment is still rising in the US and on our forecasts will not peak until mid 2010.

Chart 4: Rates rise after the peak in unemployment

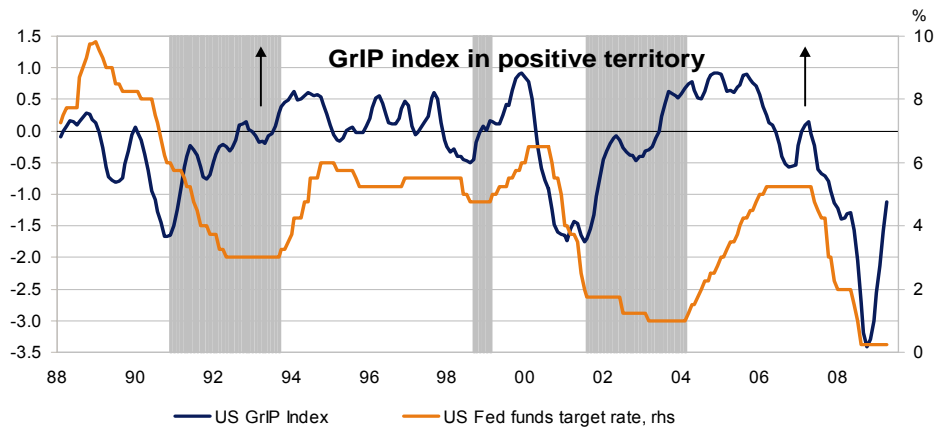


Source: Thomson Datastream, 23 September 09

More generally, the lag between economic recovery and rate rises can be seen from our Growth and Inflationary Pressure (GrIP) indices which capture a broader range of economic variables and show that rates normally only tighten once the balance of indicators has turned positive (chart 5 on next page). At present, although improving, all our GrIP indices (not just the US) are below zero.

Chart 5: US GrIP index and lags in interest rates

Standard deviations from mean



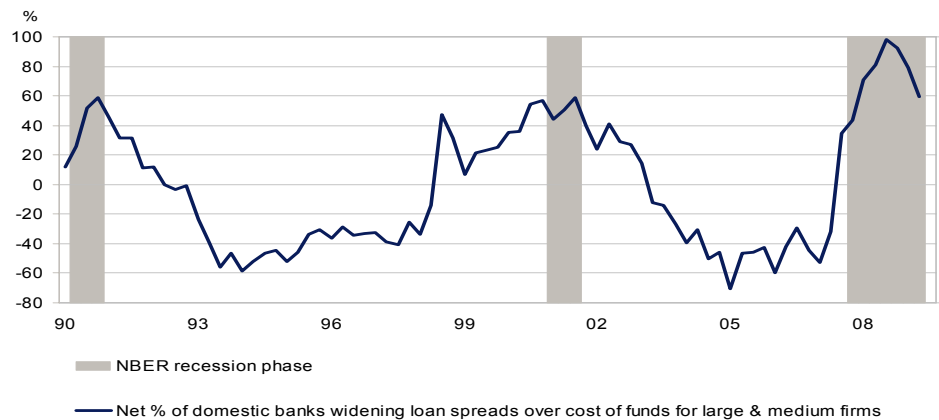
Note: Shaded areas show the period between the trough in the GrIP index and the first interest rate rise.

Source: Schroders, 23 September 09

In the meantime, low interest rates are speeding the adjustment of balance sheets by easing pressure on borrowers, many of which are taking the opportunity to repay debt. In the UK, outstanding loans to companies and individuals fell at a record pace in July. The private sector recorded its first debt repayment since records began in 1997. Whilst this goes against the Bank of England and government’s aim of increasing lending, it means that balance sheets are adjusting to a lower and more appropriate level of debt. A similar pattern can be seen in the US and Euro area where credit growth is weak or negative. In our view, balance sheet repair needs to take place before a sustainable upswing can proceed.

Balance sheet repair is also underway in the banking sector where the low level of interest rates and steep yield curve are boosting profitability and enabling institutions to rebuild capital. In the US, the latest Senior Loan Officer survey showed that banks maintained a considerable gap between the cost of funds and loan rates (chart 6). It is this margin driven recovery in earnings which has enabled banks to start repaying the funds obtained under the government’s TARP programme. An important factor in driving the recovery in equity and investment grade credit.

Chart 6: Banks continue to widen their margins



Source: US Federal Reserve, NBER (National Bureau of Economic Research), 23 September 09

Low rates plus recovery means sweet spot for markets

Low rates force investors to seek yield

This analysis suggests that returns on cash will be negligible for some time, forcing investors to continue to search for yield. Consequently, we would expect more gains for credit markets and a potential flattening of the yield curve as investors reach for longer maturities. More generally, we should see a return of carry trades with investors taking on more risk to generate income.

Companies have cut costs significantly and defended margins in the face of the downturn

Alongside continued growth, this is a favourable backdrop for equity markets. The recovery combined with aggressive cost cutting has brought a substantial improvement in earnings growth. We have upgraded our profits forecasts for US companies to -5% this year and 15% next (previously -25% and -1%). This translates into forecasts for S&P operating earnings of \$54 and \$65 next year (table 1).

Table 1: Profits, earnings per share and PE ratios for S&P 500

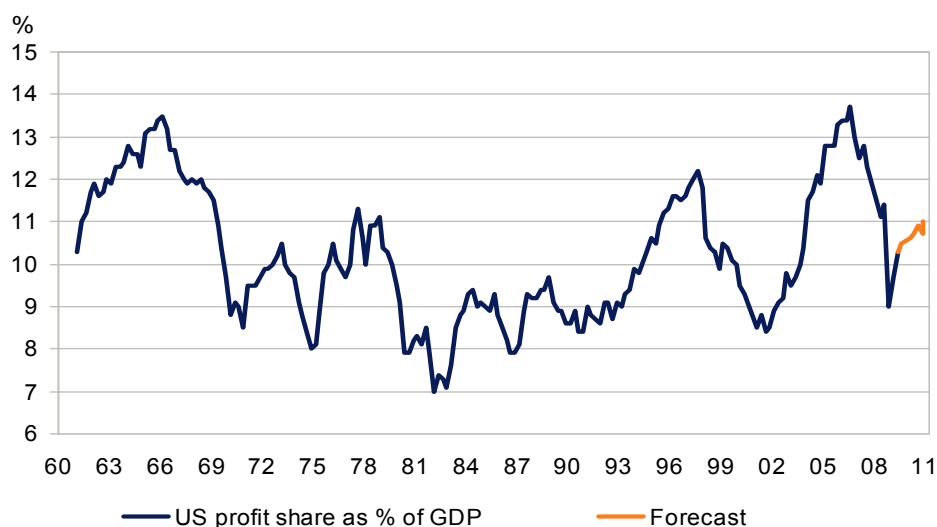
US	2008	2009	2010
Economic profits			
y/y%	-23.8	-5.3	15.2
Non.fin. profit share % GDP	6.4	6.2	7.0
S&P 500 EPS			
Operating \$	50	54 (54)	65 (73)
y/y%	-40	9	20
Reported \$	15	46	57
y/y%	-78	210	23
S&P 500 PE	market at: 1072		
Forward PE (based on operating EPS)	-	19.9	16.5
Forward PE (based on reported EPS)	-	23.3	18.8

22nd September 2009.

Figures in brackets are consensus EPS forecasts

Source: S&P, Schroders

The upgrade to earnings per share forecasts is greater than might be expected from the increase in GDP growth and reflects several factors. On the economic side, we have been surprised at the ability of firms to defend profit margins. The corporate response to the downturn has been very aggressive in terms of cuts in labour, resulting in a bounce in productivity. The response reflects the collapse in profits last year, which is now even deeper than previously recorded, and we appear to have turned the corner in terms of the profit share which is now rising (see chart 7 on next page).

Chart 7: US profit share and forecast

Source: Thomson Datastream, Schroders, 23 September 09

Write-offs have peaked

In the financial sector, we have already noted the factors supporting bank profits: low interest rates and an upward sloping yield curve are a gift to those who survived the fall out from the crisis and are benefiting from the reduction in competition. There will still be substantial write-offs to come, but we have passed the peak and their impact will diminish going forward. On a technical note, the removal of Lehman Brothers, Fannie Mae, Freddie Mac and GM from the S&P 500 index will reduce the level of write-downs going forward providing a further boost to reported earnings.

Coming back to the overall view, the combination of strong liquidity and continued earnings growth is likely to put risk assets in a sweet spot. This would represent a continuation of the second phase of the bull market described above.

Risks

We would identify two principal risks around this view:

1. Double-dip (i.e. a return to recession)

The recovery is likely to slow in the first half of 2010 creating fears of a double dip

Taking our macro forecast of a “W” shaped recovery the obvious risk is that markets fear a double dip and risk assets sell off later this, or early next year. In terms of our GDP profile we look for a bounce in US GDP in the second half of this year (to just over 2% annualised), followed by a slowdown in the first half of 2010 (to around 1% annualised). It is not a return to outright falls in GDP, but still represents a slowdown and will result in a stalling of the corporate earnings recovery.

Equity and credit markets could probably withstand this as valuations, although not as attractive as before, are not stretched. Even our sub consensus forecast for earnings would put the S&P 500 on a prospective PE of 23x on 2009 reported earnings, falling to 19x for 2010 earnings (see table 1 above). This suggests there is some cushion in valuation.

We put a 10% probability on this turning into a Japan style slump

Policy settings likely to become increasingly out of line with domestic conditions in many Asian and emerging economies

Nonetheless, if the slowdown looked like turning into something more severe, such as a Japan style slump scenario, investors would demand a greater risk premium. Equity markets are then likely to trade on lower PE ratios and credit spreads would widen. Such an outcome would probably also result in greater support from central banks either in the form of more QE or commitments to keep rates lower for longer. Bonds are likely to rally but although liquidity could remain strong, risk appetite would weaken. Equities would de-rate relative to government bonds.

At this stage, would put a probability of 10% on slump, 15% on recovery and 75% on baseline. No doubt we will return to this theme again, but given the near term outlook and growth momentum, it is probably too early for markets to look through the upswing and focus on the potential down leg next year.

2. Loose policy creates bubbles

The other risk goes in the opposite direction. Interest rates are set to remain low and the danger is that the flight from cash results in some markets becoming overheated. The greatest threat would be in those economies where monetary policy is linked to the US dollar and consequently policy remains too loose for domestic conditions.

The prime example of this would probably be Hong Kong with a monetary policy linked to the US via the peg, and an economy which is part of China. Other economies in Asia face similar issues, depending on how closely they link their currency to the USD. Consequently, there is a danger of a bubble as the authorities may do little, if anything to cool their economies as capital inflows accelerate.

This may well be a greater risk than a fall in the market as a result of fears of a double dip. Policy makers are very much focussed on the real economy at present and even if some financial markets became overheated, are unlikely to tighten and risk renewed weakness in employment and growth. In choosing the balance between providing the right amount of liquidity to the real economy and the markets, the former is likely to take priority. There is speculation that the authorities in China will move to slow credit growth and other central banks in the region (Australia, Korea) have hinted at rate rises, but fear of a significant appreciation in their currencies means that they are unlikely to move rapidly.

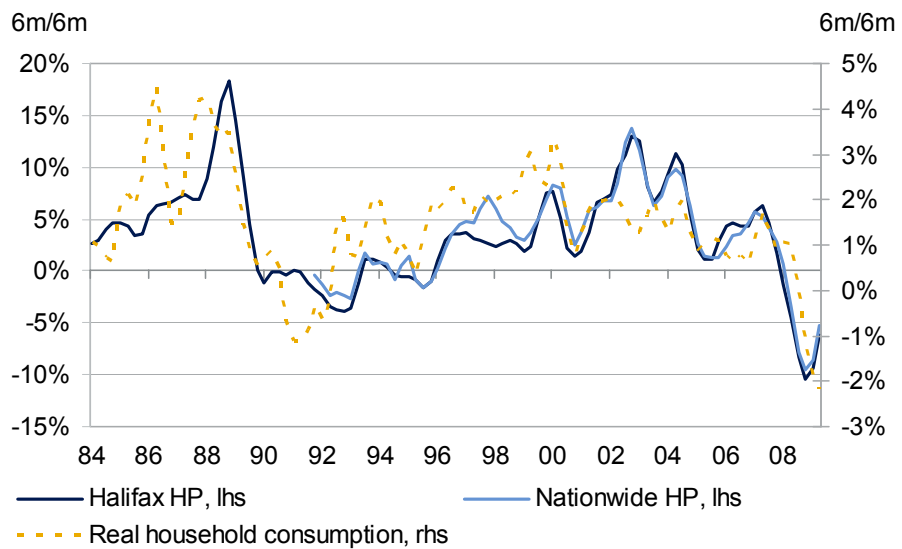
UK

A national obsession

House prices important for household consumption

Second only to the weather, the subject of house prices is the one of the biggest topics of conversation in the UK. The national obsession of owning residential properties is not only linked to the common person's aspirations of status, but often to personal consumption habits. Though the size and extent of wealth effects from appreciating property prices continues to be debated, there is little doubt that as house prices rise, consumer confidence, and as a result real consumption, rises too. Causality is very difficult to prove but the relationship remains strong (chart 8). As a result, the Bank of England keeps a close eye on housing market developments as it decides monetary policy.

Chart 8: House prices and household consumption



Source: Halifax, Nationwide, ONS, Datastream, 24 September 09

Defying gravity?

Can this be the start of the housing market recovery?

According to the Nationwide and Halifax indices for house prices (the two most popular and timely sources), house prices have been rising steadily since May (since February according to the Nationwide). Could this be the start of a housing market recovery? How can prices be rising while unemployment is soaring, wage growth has been weak, and banks restricting lending?

According to the Royal Institute for Chartered Surveyors (RICS), a combination of the return of first-time buyers and lack of supply has driven prices higher. Chart 9 on next page shows how the RICS sales to stocks ratio provides the best leading indicator for Halifax house prices on a year on year basis. Recently, the number of sales has been rising faster than the average number properties being put on the market per estate agent – indicating that further gains in prices should be expected over the coming months.

Chart 9: House prices vs. sales to stocks



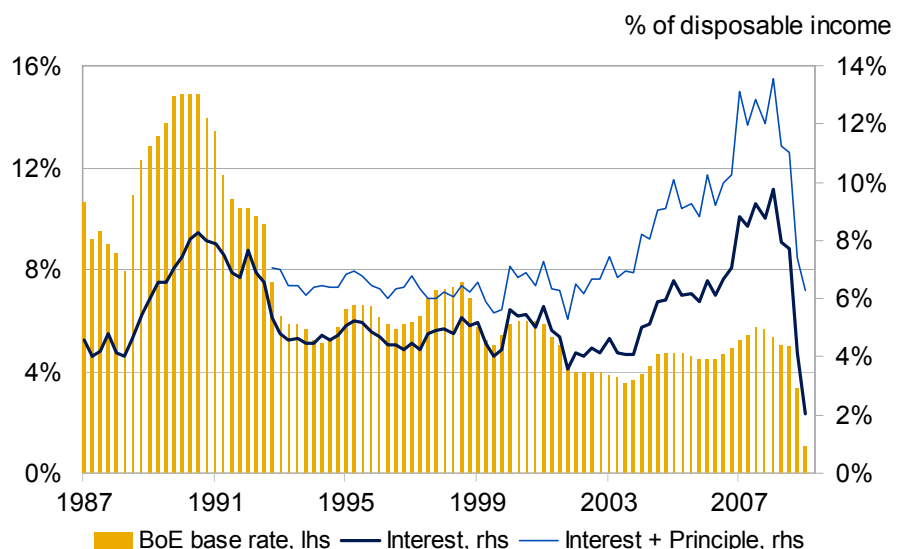
Source: Halifax, RICS, Datastream, 24 September 09

Mortgage affordability reaches 7-year high

Cheap as chips

So what has prompted new demand to return, and why are there not more distressed sellers out there? Firstly, government legislation that forces banks to hold off filing for repossessions for 12 months has delayed the surge in unwanted properties to the market. While this is a temporary fix, the second factor – record low interest rates – has also helped make servicing mortgage debt much more affordable. The average cost of servicing a repayment mortgage, relative to the national median disposable income, has now fallen to levels not seen in over seven years (chart 10). In fact, the average homeowner with an interest only mortgage now enjoys mortgage payments that are half the cost (relative to disposable incomes) they have been at any time since records began in 1987.

Chart 10: Mortgage servicing costs



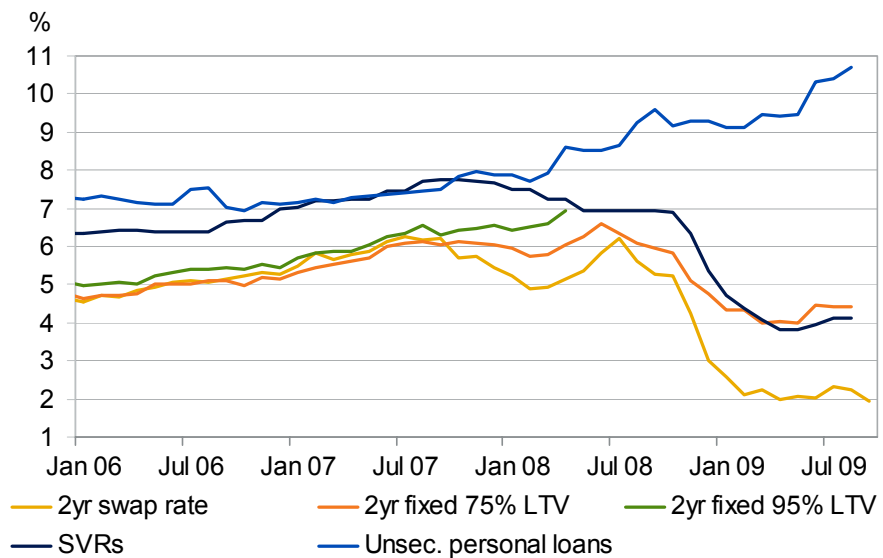
Source: BoE, ONS, Datastream, Schroders, 24 September 09

Though banks raising margins and lending standards means entry for first-time buyers remains difficult

Of course, the above chart represents the average homeowner, which has been skewed towards existing homeowners with higher equity than in previous years. According to the Council for Mortgage Lenders (CML), first-time buyers (FTBs) used to make up approximately half of all mortgage transactions a decade ago. However, that figure has fallen dramatically in recent years, with the reading for July showing FTBs now only making up 36% of the market for new mortgages. In addition, the fallout of the near-collapse of Northern Rock and wider financial crisis has meant that loan to value ratios (LTVs) have had to be reined in too. The CML reports LTVs to now average 66% (75% for FTBs), where as they averaged 71% (86% for FTBs) in July 2008.

The need for banks to rebuild their balance sheets has also meant margins between mortgage rates and wholesale rates have had to rise. Chart 11 shows how before July 2007, the average rate charged for a 75% LTV mortgage that has a fixed interest rate for 2 years, moved very closely with 2-year swap rates – the wholesale cost of guaranteeing a fixed rate for two years. Since July 2007, a significant margin has appeared, while 95% LTV mortgages have almost disappeared altogether. This partly reflecting the lack of liquidity in the market, but also the need for banks to increase their profit margins and reduce default risk.

Chart 11: Wholesale & mortgage interest rates



Source: Bank of England, Datastream, 24 September 09

Though, mortgage rates have come down, the conditions for unsecured lending (averaging £10,000) are much worse – the average cost rising by over a fifth over the past year. Interestingly, standard variable rates (SVRs) – the rate most mortgages revert to following the end of the fixed period of interest, are now cheaper than new 2-year fixed rates. This is an indication that mortgage lenders are now preparing for increased interest rates over the next two years.

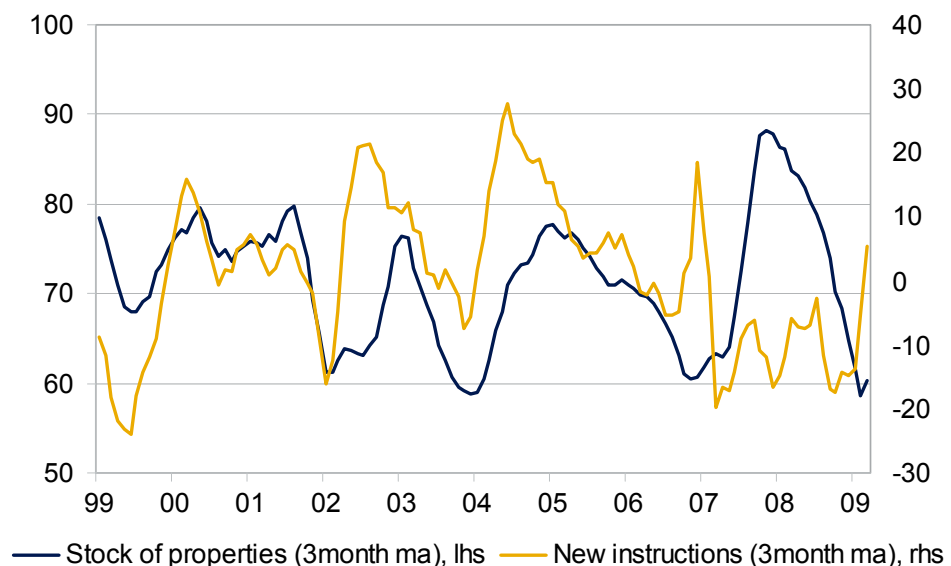
However, supply may be about to return...

And the lack of supply?

We have already mentioned the more accommodative measures in place for home owners, reducing the need to sell a property, however, according to the latest RICS report (September 2009), the average stock of homes being marketed by estate agents is significantly below normal levels for this time of year. Are sellers willing to wait for a recovery, or is there something else holding back supply? Anecdotal evidence suggests that sellers have not been able to put properties on the market as quickly as they had been able to a few years ago. They blame the Government's introduction of new Home Information Packs (HIPs), which are designed to provide buyers more information on the energy efficiency of a home, but require a survey to be carried out before a home can be marketed.

There is no hard data supporting the above, but using RICS survey data, we can see that the lag between new instructions and the stock of properties held by agents has increased (chart 12).

Chart 12: Stock of properties & new instructions



Source: RICS, Datastream, 24 September 09

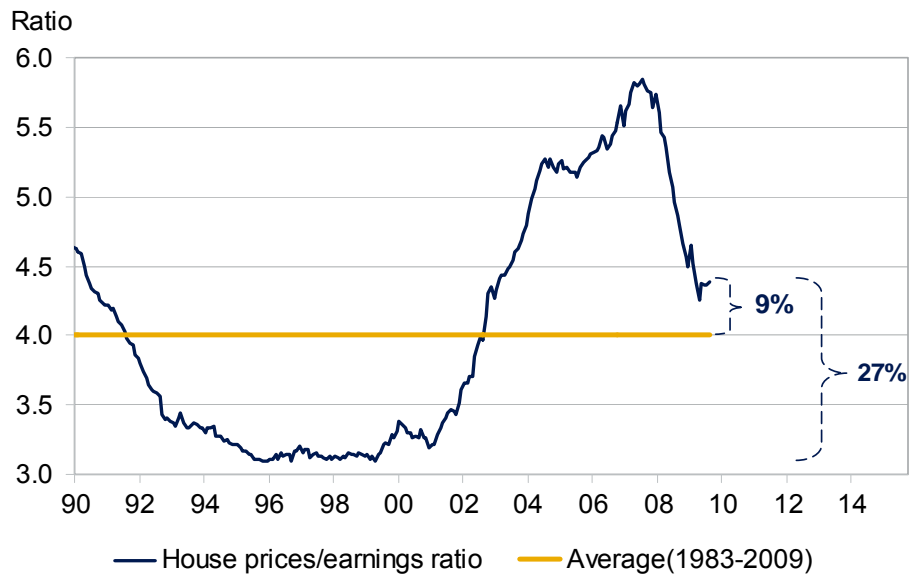
The above chart also shows that new instructions for August are at their highest level since May 2007. As new instructions lead to an increase supply to the market, we expect the sales to stock ratio in chart 9 to dip again, potentially at the start of 2010. This would coincide with VAT being raised back to 17.5%, and the debate on fiscal tightening intensifying ahead of crucial general elections – thought to be planned for May. **We believe the combination of these factors could cause house prices to fall further.**

...with property prices still fundamentally overvalued...

Still expensive

By historical standards and relative to income growth, house prices remain expensive. Chart 13 shows that while there has been a substantial correction in the Halifax house prices to earnings ratio, the measure remains above its long-term average. Assuming earnings remain constant, house prices would be 9% overvalued relative to that long-term mean, but also 27% overvalued relative to the previous trough in the ratio. Reaching the previous lows of the mid-1990s is possible. As house price movements tend to be very persistent, then tend to overshoot fair-value when correcting, with the length of time taken from peak to trough during house price crashes averaging four years.

Chart 13: House prices to earnings ratio



Source: Halifax, DataStream, Schroders, 24 September 09

Conclusion

A lack of supply of housing for sale and very loose monetary policy conditions should support further gains in house prices throughout the rest of 2009. The cost of financing a mortgage is now very low and this is attracting first-time buyers back, who have been short in numbers in recent years.

Raising the likelihood of more falls in house prices, prompting the BoE to temper future rate rises

However, latest survey evidence suggests the recent pick up in prices has encouraged more sellers back to the market. Should supply outpace demand over the coming months, then house prices may begin to fall again, particularly as pressures from higher unemployment and tighter fiscal policy mount. House prices remain expensive relative to average earnings, and with considerable slack in the labour market, we expect average earnings to remain weak over the next few years.

The Bank of England is therefore right to be cautious. At most, the real wealth effects and at least, the psychological effects from movement in house prices are important enough to pay close attention to developments. Should house prices resume the correction that started at the end of 2007, the Monetary Policy Committee would be forced to temper rises in interest rates over 2010 and 2011.

Forecast Summary

Real GDP						
y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	0.4	-2.7	-2.6	1.6	2.4
UK	5.8	0.7	-4.5	-4.3	0.7	1.1
Eurozone	25.5	0.6	-3.9	-3.9	1.0	1.0
Japan	9.2	-0.7	-5.0	-5.7	1.3	1.5
Australia	1.9	2.5	0.3	0.8	1.8	2.4
OECD	71.4	0.4	-3.5	-3.5	1.3	1.7
China	7.1	9.0	8.0	8.3	8.8	9.4
Emerging*	28.6	6.3	1.3	0.5	4.3	4.9
World	100.0	2.1	-2.1	-2.4	2.1	2.6
Inflation CPI						
y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	3.8	0.4	-0.5	2.0	1.9
UK	5.8	3.6	2.0	1.9	1.7	1.8
Eurozone	25.5	3.3	0.7	0.3	1.3	1.2
Japan	9.2	1.7	-1.5	-1.3	-0.6	-0.8
Australia	1.9	4.5	1.7	1.7	2.2	2.3
OECD	71.4	3.3	0.4	0.0	1.4	1.3
China	7.1	5.9	-0.5	-0.6	2.0	2.3
Emerging*	28.6	7.9	3.0	4.2	4.0	4.8
World	100.0	4.7	1.2	1.2	2.1	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	0.44	1.50	1.82
UK	5.8	2.00	0.50	0.51	2.00	2.47
Eurozone	25.5	2.50	1.00	0.73	2.00	1.93
Japan	9.2	0.10	0.10	0.48	0.25	0.59
OECD	69.5	1.52	0.53	0.56	1.56	1.75

Market data as at

22/09/2009

Key variables

FX	Current	Dec-08	Dec-09	y/y%	Dec-10	y/y%
USD/ GBP	1.64	1.49	1.65	11.0	1.55	-6.1
USD/ EUR	1.48	1.35	1.35	-0.2	1.45	7.4
JPY/ USD	91.1	91.1	97.5	7.0	92.0	-5.6
GBP/ EUR	0.90	0.91	0.82	-10.1	0.94	14.3
Brent crude	69.2	40.5	72.2	78.1	78.3	8.5
US output gap %GDP	-7.9	-4.1	-7.8		-8.0	
Unemploy. %	9.3	6.9	9.6		10.2	

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

Our forecasts for global growth have been raised since the last CMF with the world economy now expected to contract by 2% this year before growing at just over 2% in 2010. These figures are about 1 percentage point stronger than forecast at the last CMF. The upgrade has largely been driven by a better than expected GDP performance in the second quarter and an improvement in business surveys. The biggest forecast increases have been made in Europe and Japan.

Forecasts for the emerging markets have also been raised in response to the upgrade to OECD growth and the continued strength of China which has continued to enjoy upgrades as fiscal policy has boosted activity.

The recovery is expected to be driven by the industrial sector as the inventory cycle turns and stronger government spending kicks in. The main impact of this will be felt in the second half of 2009 and we would look for growth to fade in 2010 as consumer spending and final sales are constrained by ongoing deleveraging in the household sector, tax increases and higher commodity prices.

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 inflation (CPI ex. food and energy) through 2010.

Interest rates are now expected to rise slightly earlier in 2010 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.

Growth: US GDP forecast raised to -2.7% for 2009 from -3.1% with the economy returning to growth in the second half of the year. In 2010 we now look for growth of 1.6% compared to 0.8% at the last CMF.

- Amongst the OECD, despite an upgrade, Japan is still forecast to experience the greatest fall in GDP this year, a reflection of the hit to global trade. Forecasts for the UK and Eurozone have also been raised.

- OECD activity now forecast at -3.5% in 2009 compared to a previous estimate of -4.4%.

- Emerging market growth has been hit by weaker external demand and pressures on those economies with balance of payments deficits particularly in Central and Eastern Europe. However, the emerging markets are expected to accelerate to 4.5% in 2010.

Inflation: The combination of a significant output gap and lower energy prices push inflation forecasts for 2009 down to 0.4% for the OECD and 3% for the EM, taking global inflation to 1.2% (after nearly 5% in 2008). These forecasts are a little higher than 3 months ago to reflect higher commodity prices.

- Inflation picks up in 2010 in line with commodity prices, however core rates drift lower as slower growth creates slack and squeezes pricing power.

(Note: We use forward futures rates for commodity price assumptions).

Monetary policy: Central banks are expected to leave rates at current levels until the middle of next year with the Bank of England and the Fed continuing with quantitative easing. Despite low inflation, the continuing recovery means that central banks decide to end the period of ultra-loose policy put in place following the collapse of Lehman and the seizing up of the financial system. The forecast of weak growth and low inflation means policy in the US and Europe is still considered to be loose by historic standards.

Currency: Following its recent decline we see scope for the USD to appreciate as evidence of recovery builds and the Fed upgrades its assessment of the economy. However, looking further out we expect the twin deficits to push the USD lower against the EUR and JPY.

- The GBP is expected to be relatively firm in the near term and move in line with the USD. Next year we expect underperformance as markets focus on the fiscal position and political risk in the run up to a general election.

September 2009

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

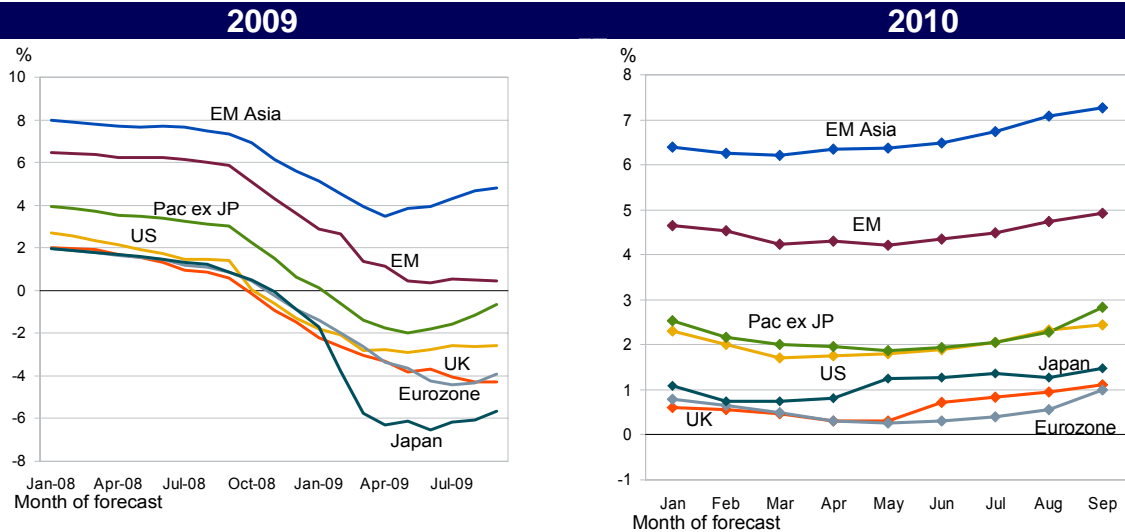
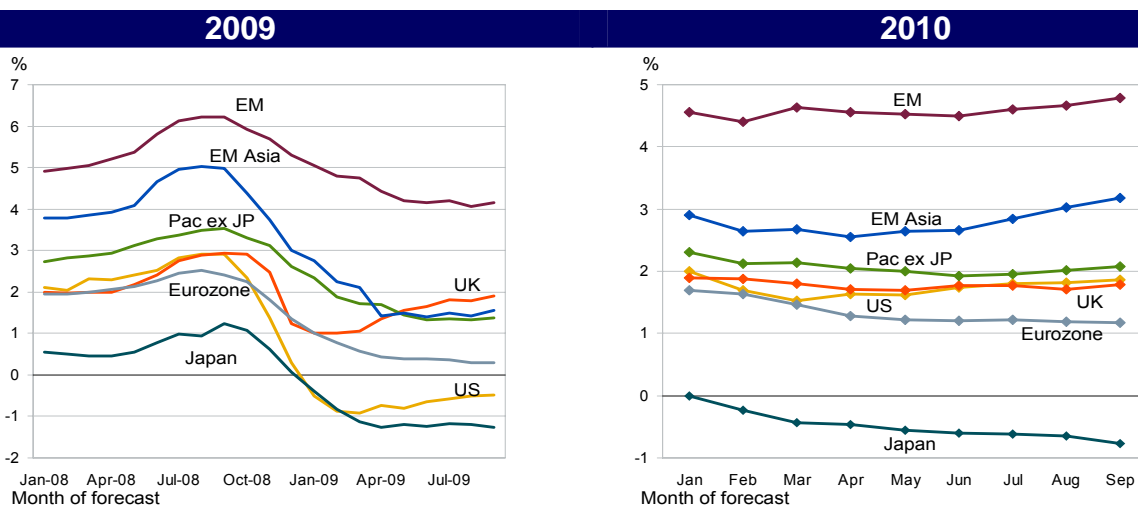


Chart B: Inflation consensus forecasts



Source: Consensus Economics (Sep. 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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