Schroders
Economics and Strategy Viewpoint

Keith Wade
Chief Economist and Strategist
(44-20)7658 6296

Tina Fong
Analyst, Multi-Asset
(44-20)7658 3278

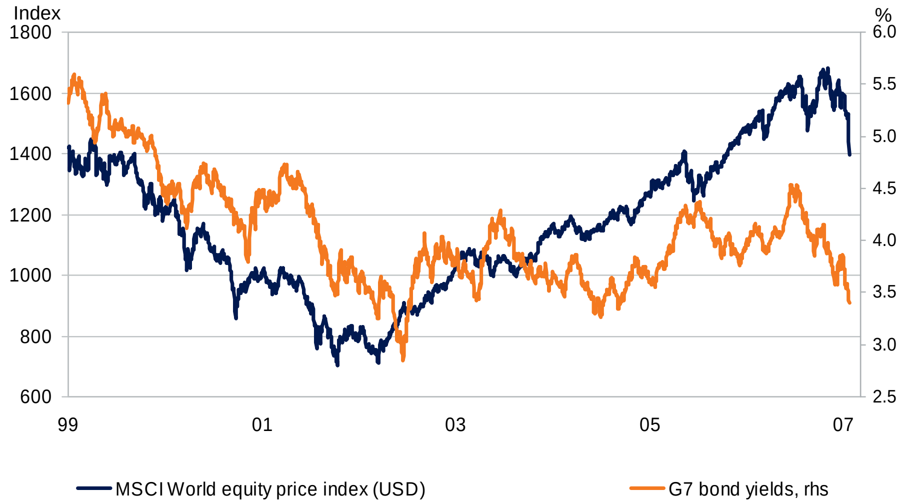
Harish Vekaria
Quantitative Analyst
(44-20)7658 2722

Global Views: Outlook darkens as US recession risks rise (page 2)

- **The risk of a recession has increased in the US following a run of poor data showing the economy loosing momentum at the end of last year. The downturn has broadened beyond the housing market to consumer and corporate spending. So far though, growth outside the US is holding up, but we expect the de-coupling hypothesis to be challenged in 2008.**
- **Financial markets are now focussed on the growth outlook with equities falling and government bonds rising in value (see chart). Risk aversion has risen as investors recognise that the credit crunch is feeding through to the real economy.**
- **There is a danger of a self feeding downturn as banks withdraw credit, weakening the economy and making lenders even more cautious as asset values and incomes decline. To break this we need to see banks clearing their balance sheets of bad debt through write-offs, re-structuring and reductions in dividends. Such actions are taking the sector in the right direction, but at this stage are only reinforcing caution.**
- **The Federal Reserve is also moving to mitigate the effects of the downturn and we now expect the US central bank to reduce rates to 2.5% by June. Such rate cuts combined with a potential easing of fiscal policy will eventually support activity, but it is too early to turn bullish. Our analysis says we are still in the slowdown phase of the cycle: the period when equities underperform cash and markets experience the most volatility.**

Forecast summary (page 5)

Equities follow bond yields lower as recession fears rise



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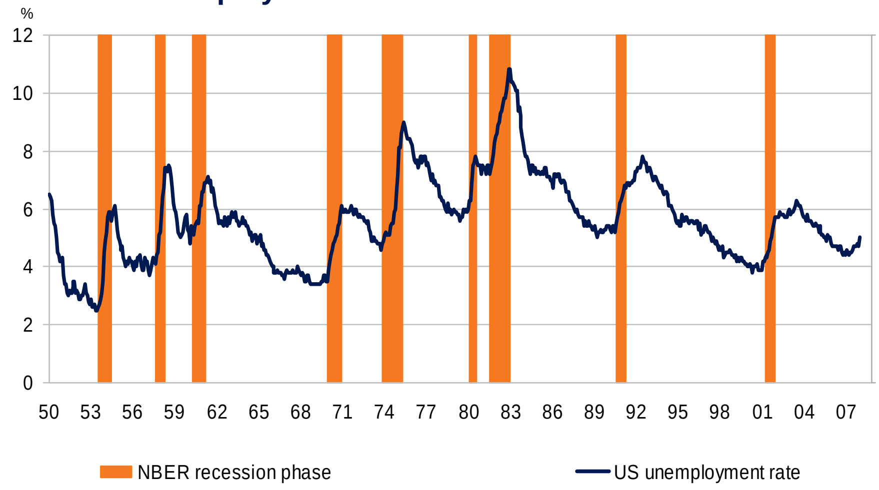
Global Views

Outlook darkens as US recession risks rise

Downturn broadens to corporate and consumer spending in the US

The US economy took a significant turn for the worse at the end of last year with unemployment rising sharply and business surveys indicating a sharp down turn in activity (chart 1). Housing remains weak with prices and starts falling as the market attempts to clear. Meanwhile there is evidence that the slowdown is spilling over into consumer spending with retail sales falling in December. On the corporate side, there are also signs of weakness with orders for capital goods falling back in the final quarter of 2007.

Chart 1: US unemployment and recessions



Source: Thomson Datastream, National Bureau of Economic Research (NBER)

US could now be in recession

It is quite possible that the US economy has now entered a recession, the first since 2001. This would not be in the strict European sense of two consecutive quarters of falling GDP, but as defined by the National Bureau of Economic Research (NBER) the official arbiter of the business cycle who define recession with reference to a selection of monthly spending and output indicators. The US economy is still likely to achieve positive GDP growth of around 1.5% annualised in the first half of the year, but for an economy with a trend rate of growth of 3% this will be recessionary.

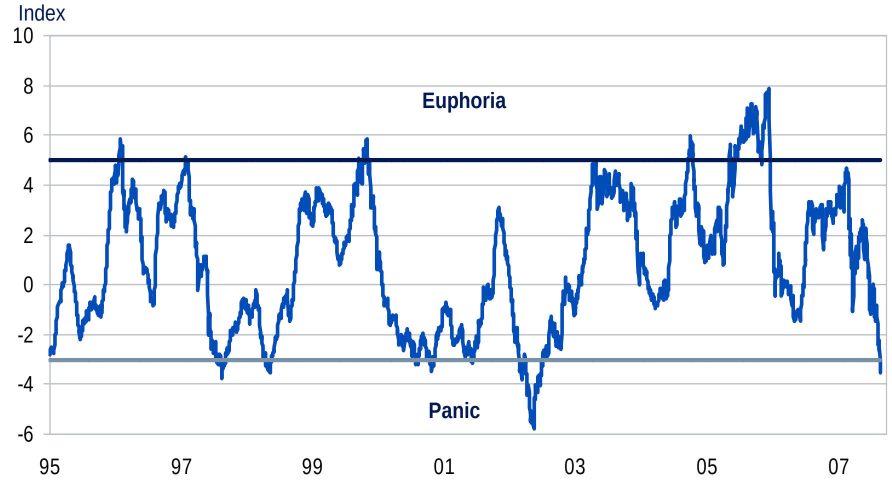
De-coupling under threat?

Outside the US, economic activity appears to be holding up with the Purchasing Managers indices in Europe and Asia remaining in expansion territory. It is notable that while analysts have begun to downgrade their estimates for US and European earnings over the next 12 months, upgrades are still the dominant theme in Asia and the wider emerging markets. In this respect, the de-coupling hypothesis remains intact. Nonetheless, there are some tentative signs of a softening in Asian activity with a number of export figures surprising on the downside recently. This also ties in with the sharp fall in the Baltic freight index which captures the cost of shipping and is sensitive to changes in global trade flows.

Growth fears driving markets

Meanwhile, markets have become increasingly pessimistic judging from the fall in equities and rally in government bonds – evidence of increased risk aversion, which is hitting 'panic' levels (chart 2). Investors have chosen to focus on the deteriorating outlook for US growth rather than more positive developments such as the narrowing of spreads in the interbank market or reduction in the TED spread.

Chart 2: Risk appetite index hits panic

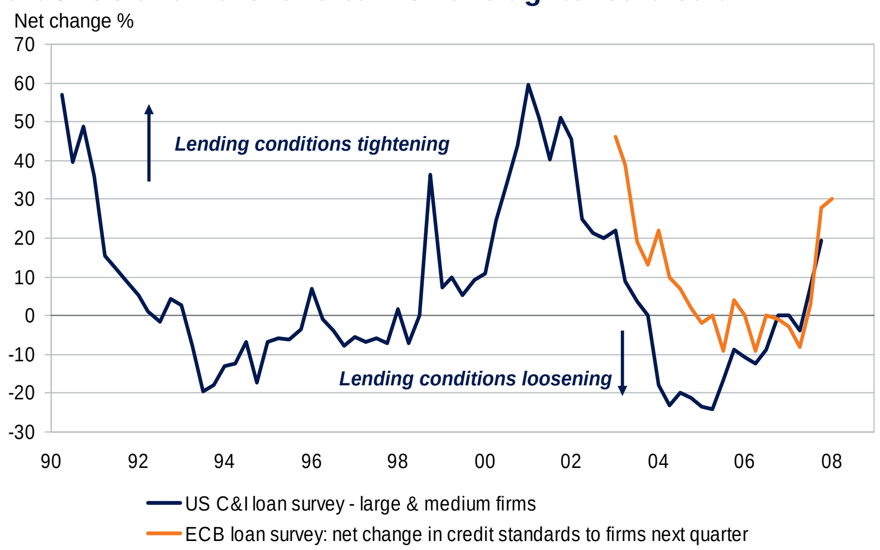


Source: Credit Suisse

Credit crunch is spreading from the financial to the real economy

The conclusion would seem to be that the credit crunch is already damaging the real economy and that these improvements in money markets are coming too late. There is already evidence that lenders are tightening credit lines to households and companies. Surveys show that banks have become more cautious and this is likely to continue as the sector responds to heavy losses in sub-prime by shrinking its balance sheet (chart 3).

Chart 3: US and Eurozone banks have tightened credit



Source: Thomson Datastream

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Danger of a self-feeding downturn

The danger is that as this impacts the economy, there is a further restriction in credit as banks worry about the value of the collateral they are lending against or the security of the cash flows which are designated to pay interest. Falling house prices and rising unemployment do not increase banks willingness to lend. Consequently, there is a danger of a downward spiral in activity as the banking sector increasingly retreats in on itself.

The 3 R's

On its own, sub-prime losses should not be great enough to cause a major slump in global activity. Furthermore, the banks have been successful in obtaining capital to re-capitalise themselves. Write-offs, re-structuring and reductions in dividends have been the main theme of the recent reporting season. Nonetheless, the experience of past banking crisis is that central banks need to act aggressively to stimulate activity and even then recovery tends to be slow.

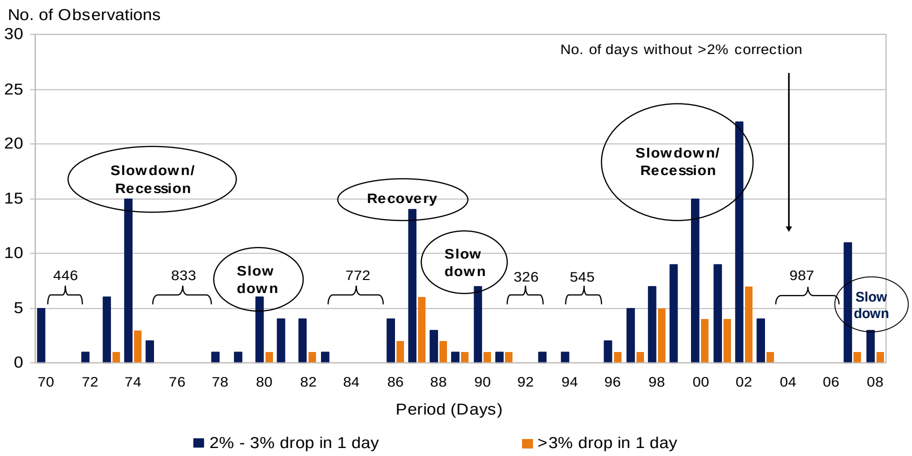
Greater policy easing expected

We have already been looking for a step down in US growth before the recent spate of poor data, but in recognition of the greater headwinds facing the economy have reduced the forecast Fed funds target rate and now expect rates to fall to 2.5% by June this year. The risk to this forecast is that rates are lower rather higher. Fed chair Bernanke has made it clear that he is prepared to take the 'substantive additional action needed to support growth,' and clearly could not wait until the next Federal Open Market Committee (FOMC) before cutting 75bps today. The deterioration in the outlook for the US will add pressure for rate cuts elsewhere, particularly in the UK (where we now expect rates to fall to 4.5% by year end). It will also put further downward pressure on the US dollar.

Difficult phase for risk assets – stay underweight

In terms of our asset allocation framework we would now put a probability of 55% on the baseline (previously 60%), 30% on a credit crunch scenario (previously 25%) and 15% on stagflation (unchanged). Our cyclical analysis says we are still in the 'slowdown' phase of the cycle: the period when equity markets underperform cash and are most vulnerable to correction (chart 4). We would be looking for evidence that the economy is moving through this phase and that the Fed is getting ahead of the curve before moving back into equities.

Chart 4: Occurrence of market correction of more than 2% in 1 day



Source: Schroders

Forecast Summary

I. Forecast summary

Real GDP

y/y%	Wt (%)	2005	2006	2007	Consensus	2008	Consensus
US	32.7	3.1	2.9	2.1	2.2	2.1	2.0
UK	5.9	1.8	2.8	3.1	3.1	1.8	1.8
Eurozone	26.6	1.5	2.9	2.5	2.6	1.8	1.8
Japan	13.0	1.9	2.2	1.9	1.9	1.8	1.5
Australia	1.6	2.8	2.7	4.1	3.9	3.3	3.6
OECD	79.8	2.3	2.8	2.3	2.4	2.0	1.9
China	5.8	10.4	10.7	11.4	11.3	10.5	10.4
Emerging*	20.2	6.5	7.1	7.2	7.2	6.9	7.0
World	100.0	3.1	3.6	3.3	3.4	3.0	2.9

Inflation CPI

y/y%	Wt (%)	2005	2006	2007	Consensus	2008	Consensus
US	32.7	3.4	3.2	2.9	2.9	3.1	2.8
UK	5.9	1.9	2.7	2.3	2.3	2.0	2.3
Eurozone	26.6	2.2	2.1	2.1	2.1	2.4	2.4
Japan	13.0	0.0	0.1	-0.1	0.0	0.3	0.4
Australia	1.6	2.7	3.5	2.3	2.4	2.6	3.1
OECD	79.8	2.3	2.3	2.1	2.1	2.3	2.2
China	5.8	1.8	1.5	4.6	4.6	4.5	4.3
Emerging*	20.2	4.6	4.5	4.9	5.3	5.0	5.0
World	100.0	2.8	2.8	2.6	2.7	2.9	2.8

* ***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, Russia, Bulgaira, Croatia, Estonia, Latvia, Lithuania, Slovenia, Ukraine (weights are at 2006 US$)*

Interest rates

%	Wt (%)	Dec-06	Dec-07	Dec-08	Market
US	32.7	5.25	4.25	2.50	2.52
UK	5.9	5.00	5.50	4.50	4.54
Eurozone	26.6	3.50	4.00	3.50	3.60
Japan	13.0	0.25	0.50	1.00	0.60
OECD	78.2	3.81	3.64	2.88	2.82

Market from forward futures strip as at 21/01/2008

Key variables

FX	*Current*	Dec-06	Dec-07	Dec-08	y/y%
USD/ GBP	*1.94*	1.96	2.02	1.88	-6.8
USD/ EUR	*1.45*	1.32	1.46	1.50	3.1
JPY/ USD	*105.7*	117.4	112.41	102.50	-8.8
GBP/ EUR	*0.74*	0.67	0.72	0.80	10.5
Brent crude	*87.9*	62.3	91.4	87.5	-4.3
US output gap %GDP	*0.3*	0.3	0.0	-0.6	
Unemploy. %	*4.8*	4.5	4.8	5.3	

Source: Schroders, Datastream, IMF (historic), Consensus Economics (January)

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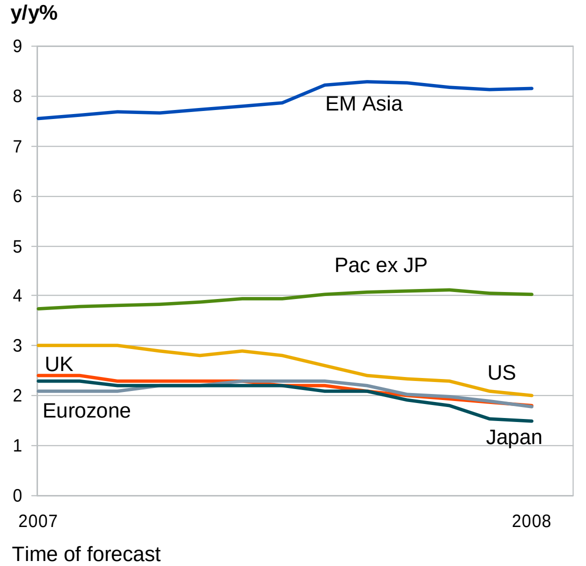
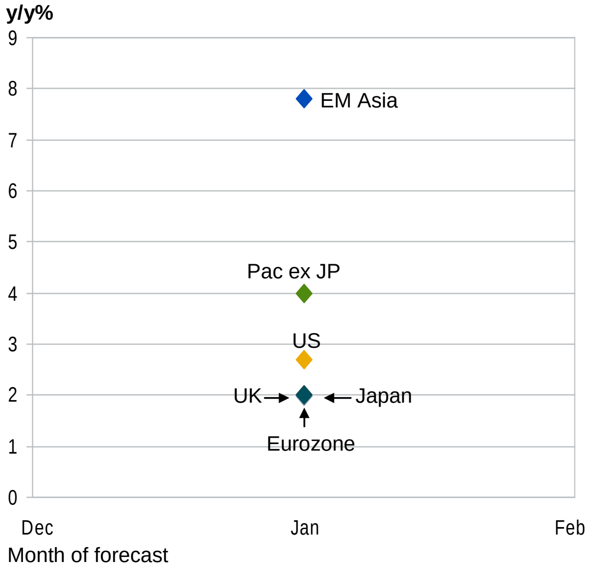
II. Updated forecast charts

Chart 1: GDP forecasts

2008	2009



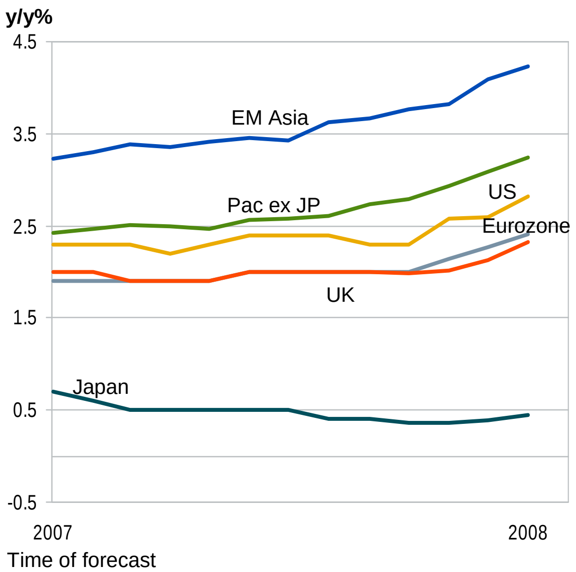


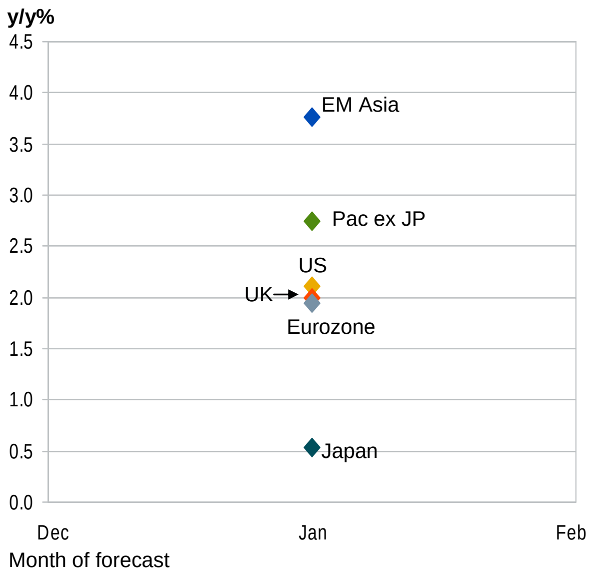
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

Source: Consensus Economics (Jan.), Schroders 2006 GDP weights

Chart 2: Inflation forecasts

2008	2009

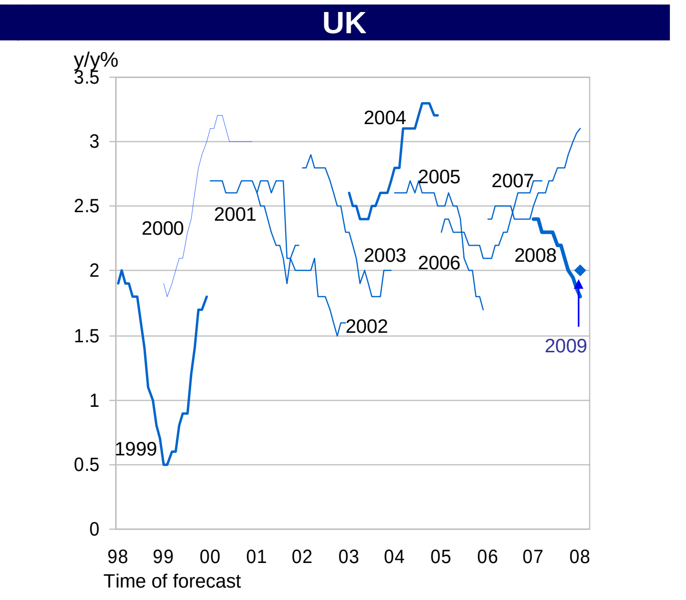




Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

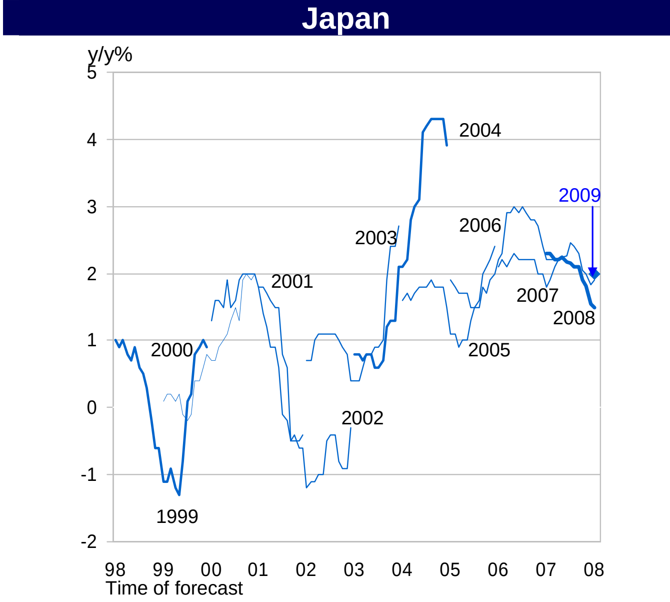
Source: Consensus Economics (Jan.), Schroders 2006 GDP weights

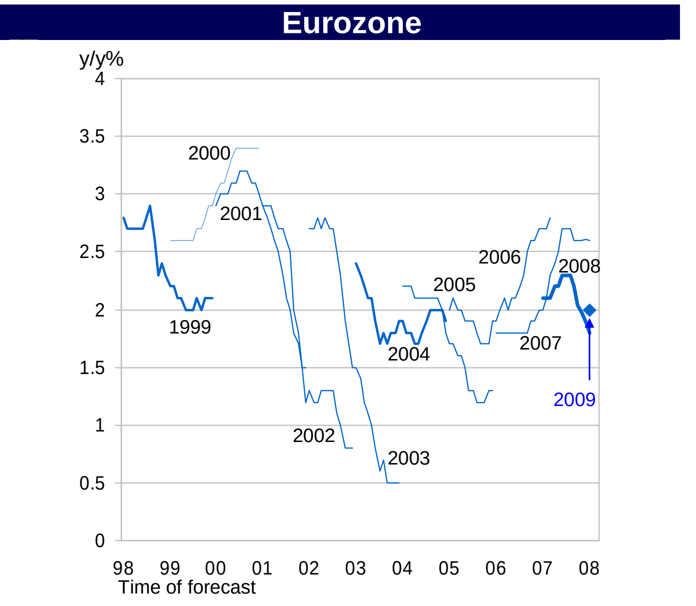
Chart 3: US and UK GDP forecasts



Source: Consensus Economics (Jan.), Schroders

Chart 4: Japan and Eurozone GDP forecasts





Source: Consensus Economics (Jan.), Schroders

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