

Schroders

Economics and Strategy Viewpoint

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

Robert Sierra
European Economist
(44-20)7658 2011

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

Harish Vekaria
Quantitative Analyst
(44-20)7658 2722

Global: Into the valley (page 2)

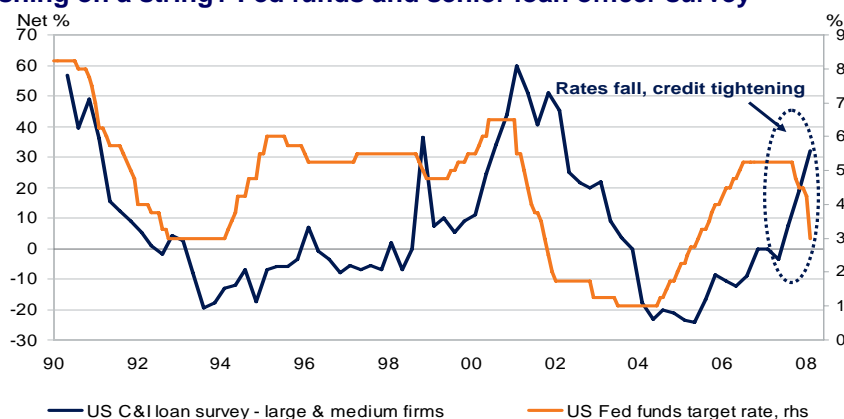
- The US appeared to dive off a cliff as we entered 2008, a signal that the economy is probably in recession. Meanwhile, consensus growth forecasts have been cut in Europe and Japan although the de-coupling hypothesis remains intact for the Emerging markets where forecasts remain firm.
- Aggressive rate cuts from the Federal Reserve are a classic response to the threat of a liquidity trap, a situation where the central bank appears to be pushing on a string in its efforts to revive economic growth. As yet there is little evidence that rate cuts are persuading the banks or bond markets to boost credit availability. Risk aversion prevails and we now expect the Fed to cut rates to 2% by May (see chart).
- We would expect the US growth profile for 2008 to be more of an “L” shape than a “V” – as is typical from an economy emerging from a financial crisis. This could be offset by stronger growth in the rest of the world, although given current inflation pressures we would see little scope for a major acceleration in activity outside the US.

European and UK: softer stance at the ECB (page 5)

- The European Central Bank (ECB) has changed its stance to a more neutral position. While this does not signal an immediate change in policy, it opens the door for a rate cut if activity continues to deteriorate.
- Whilst markets expect a rate cut to some as soon as April we believe this is too early and expect the first cut in the second half of this year once wage negotiations prove to be moderate.
- It is likely that the ECB will have to reduce their forecasts for growth and inflation when new staff macro projections are made in March. This would send a further signal that they are gearing up for a cut in rates.
- The Bank of England (BoE) signalled its intention to ease at a gradual pace. We believe that weakness in economic activity will require the Bank to cut rates by a further 75bp to 4.5% during 2008.

Forecast summary (page 12)

Pushing on a string? Fed funds and senior loan officer survey



Source: Thomson Datastream



Global

Into the valley

Discontinuity signals recession

One of the characteristics of a recession is a sudden drop off in activity, the point at which a slowdown turns into something more serious. Economists term this a discontinuity or a break in the data and it is this pattern which makes recessions so difficult to spot from simply tracking the daily data releases. There is evidence that we have hit such a point in the US with several indicators taking a tumble over the past month.

For example, the service sector ISM fell to its lowest level since the last recession in 2001, consumer confidence reached a 16 year low and we saw the first fall in payrolls for 4 years as firms trimmed jobs in construction and manufacturing. Meanwhile, activity in the housing sector remained weak and consumer spending has levelled off. The economy lost momentum at the end of last year with GDP rising just 0.6% at an annualised rate in the fourth quarter. It is quite possible that this tipped over into a negative quarter in Q1 this year.

Bernanke responds to threat of liquidity trap

The Fed has not been slow to respond and cut rates by a further 50 basis points to 3% at its last meeting to bring the cumulative easing to 225 bps in this cycle. Fed chairman Ben Bernanke has shown that he will adopt an activist stance in the face of downside risks to activity, a departure from the gradualist approach of his predecessor Alan Greenspan. Bernanke is a student of the Great Depression in the US and so is well aware of the dangers of allowing confidence to slide and the economy falling into a liquidity trap. Sometimes described as pushing on a string, this was also the situation in Japan during the 1990s, where lower interest rates failed to stimulate activity.

Credit conditions tightening despite rate cuts

The current situation is not as severe as in these episodes, but does share the essential characteristic that the transmission mechanism from central bank rate cuts to the real economy is impaired and not functioning normally. This, of course, is the credit crunch where banks are tightening or withdrawing credit from the economy even as interest rates fall. Evidence of this is found in the continued tightening of lending conditions apparent in the Fed's senior loan officer survey despite the fall in policy rates (see chart on front page).

It is this headwind which policy makers not just in the US, but also in the Eurozone and UK need to overcome. The problem extends into the markets for securitised debt which have in many cases dried up. In response to this and the weaker near term performance of the economy, we have reduced our forecast for the Fed funds target rate to 2% by May (previously 2.5%).

Such an outturn is typical when an economy emerges from a financial crisis and reflects the fact that the private sector is engaged in repairing its balance sheet rather than taking on new credit. Today we see this behaviour in the financial sector which has become more risk averse and although there has not been a major retrenchment by consumers, it is hard to see the housing market leading a robust recovery. It is more likely that a more restrictive environment fosters a rebuilding in savings rates.

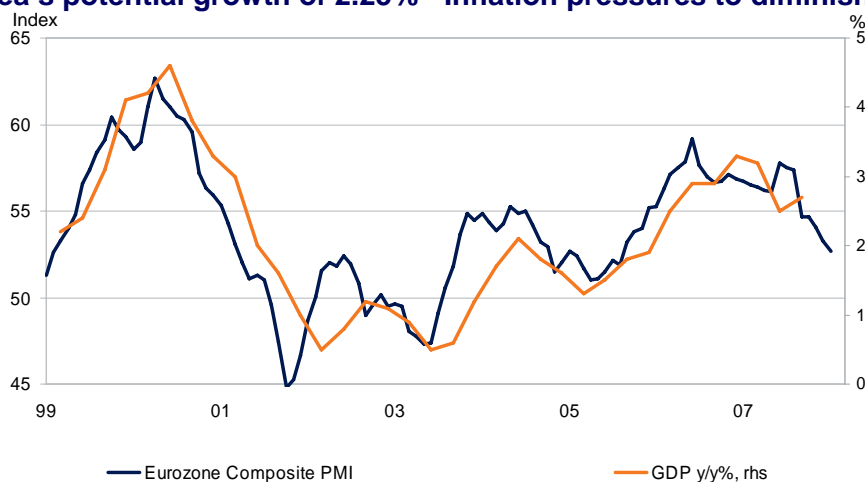
Eurozone and UK

ECB softens

ECB likely to revise growth forecasts in March

Following a string of poor data releases over recent weeks the ECB softened considerably its rhetoric, admitting that the economy is weakening more than anticipated. Only last month the message sent by the Bank was that inflation risks were on the upside and that while risks to growth were on the downside the economy was nevertheless fundamentally solid. But recent business surveys provide evidence that the slowdown is gathering pace and most notably in the retail and services sector, where PMIs (Purchasing Manufacturing Index) for Germany, Spain and Italy recorded a below 50 reading, signalling contraction, with only France managing to stay above that level, but only just. The combined manufacturing and service sector PMIs (chart 2) suggests that growth in 2008 is likely to be closer to 1.7% rather than the 2% currently expected by the ECB, a projection made last December and one which is likely to be downgraded when the new ECB staff macro projections are made in March.

Chart 2: Forward looking PMIs point to slowing growth – to below area’s potential growth of 2.25% - Inflation pressures to diminish



Source: Bloomberg

ECB opens door for rate cuts but April too soon – wage round key

The change in the ECB’s position to a more neutral stance does not signal an immediate change in policy but does open the door for a rate cut if economic activity continues to deteriorate and importantly, if wage growth remains subdued. This is a key variable in monetary policy decision in the near term, the other being the high growth on money supply M3. On the former, the ECB assumed in the December forecast that inflation would meet its medium term target of “below but close to 2%” even on the assumption of higher wage settlements than those seen in recent years. The thinking is that while labour productivity growth should moderate as the economy slows down, the effects on inflation of the resulting higher unit labour costs are expected to be offset by declining growth in corporate profit margins.

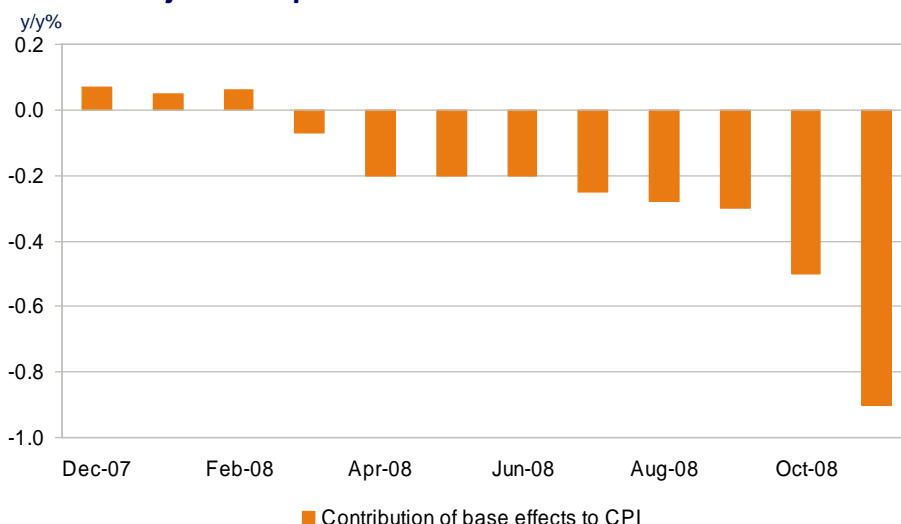
Labour market – second round effects

No threat from wage round

The potential worry for the central bank, as well as the outlook for profits, is that in a climate where growth has been above trend and one where the labour market remains tight along with rising inflation (albeit temporarily and limited to food and energy), trade unions have a better bargaining position and hence can push for higher wage settlements. With headline grabbing wage deals of 11% by the rail union in Germany and an 8% claim by the IG Metall union representing 3.2 million workers, it is clear why the ECB should be trying to counter these inflation busting pay increases.

However, we believe that wage growth is not likely to lead to significantly higher inflation ahead. First, trade unions usually aim high, but final wage settlements tend to be much lower - in past years these have tended to be some 50-60% lower than the initial request. Second, inflation is likely to fall over the course of the year, as the sharp increases in food and energy in the second half of 2007 drop out of the annual comparison (Chart 3).

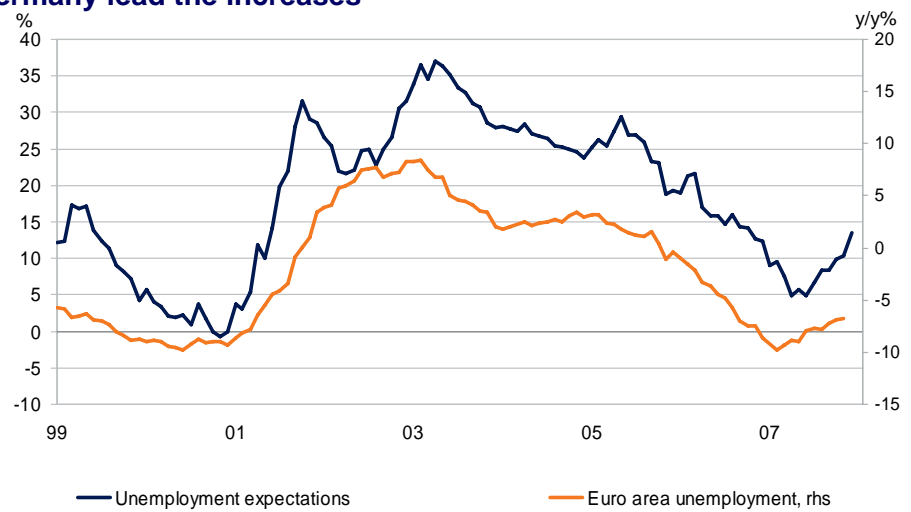
Chart 3: Projected impact of base effects on annual Eurozone CPI



Source: ECB

Third, the labour market is weakening with job creation past its peak and in some countries, namely Spain and Italy, unemployment has already started rising ahead of the rest of the Eurozone and will put a brake on large wage claims; the latest European Commission survey on unemployment expectations shows that labour market uncertainty is growing (chart 4 on next page).

Chart 4: Unemployment in the Eurozone stops falling – Spain and Germany lead the increases



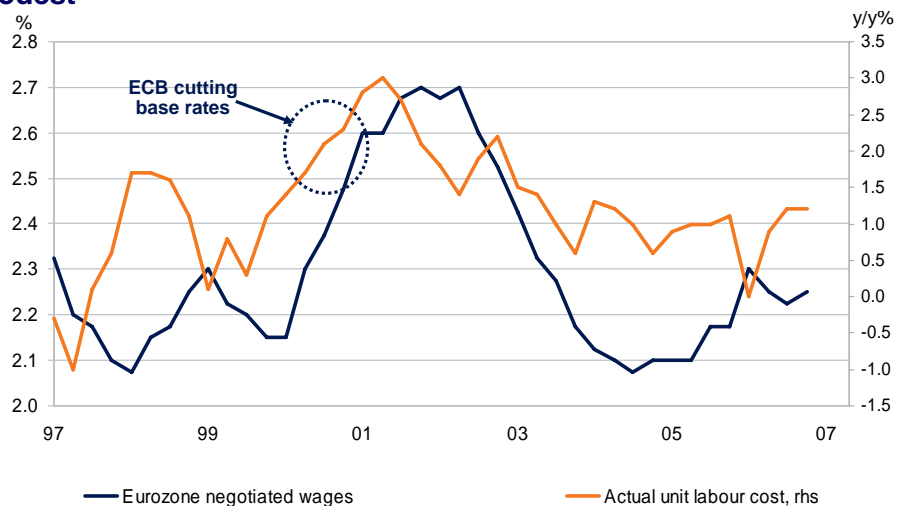
Source: Thomson Datastream

Fourth, while wage settlements could result in higher wage growth, these are likely to be up only modestly on last year's 2.3% in line with the ECB index of Negotiated Wages (chart 5). In terms of overall labour costs, note that these will rise modestly from the current rate of 1.2% in line with slower productivity gains, but remain within the confines of what is consistent with price stability.

Higher labour costs have not stopped ECB cuts previously

In terms of monetary policy, note that even when labour costs were growing at 2.1%, the ECB nevertheless embarked on a series of rate cuts which reduced rates by 150bp alone in 2001. Labour costs continued to rise peaking at 3% in early 2002.

Chart 5: Eurozone labour costs are low and negotiated wages modest

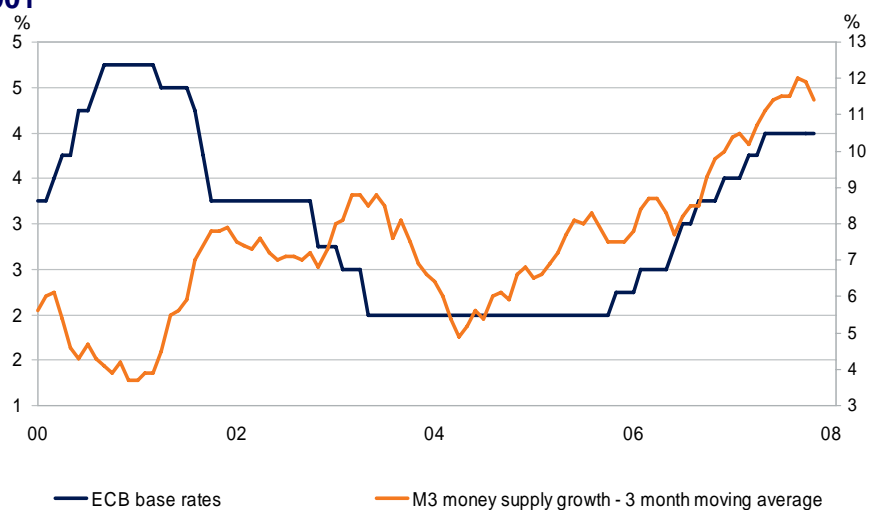


Source: Thomson Datastream

The other obstacle to a near term cut in rates at present is the still high growth in money supply M3. Although money growth softened recently the underlying rate of monetary expansion remains strong. This is supported by the sustained expansion of loans, particularly to non-financial corporations, although the latest ECB's quarterly credit survey points to a significant tightening in lending standards ahead.

Our view remains that the ECB will begin easing interest rates in the second half of this year, cutting by a total of 50bp to 3.5%

Chart 6: M3 growth much lower when ECB started easing cycle in 2001



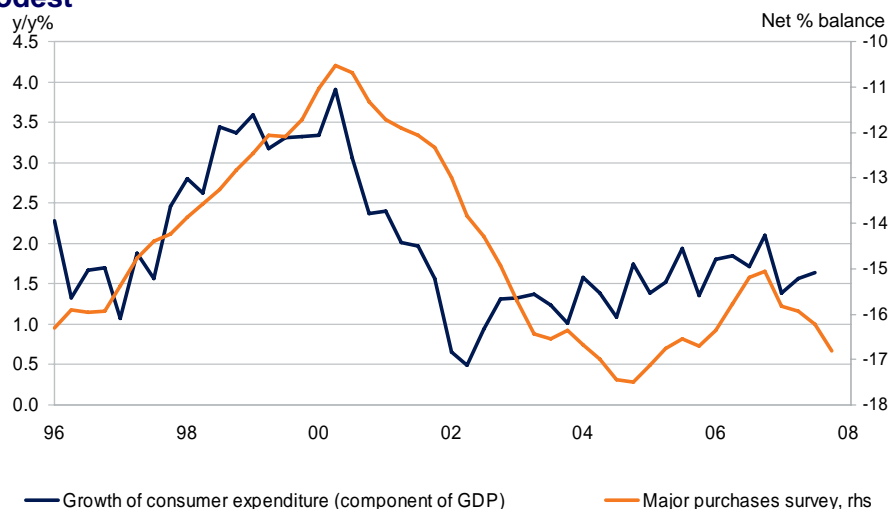
Source: Thomson Datastream

Looking ahead, exports, investment weakening; consumer spending the new risk

Having experienced solid growth over recent quarters on account of strong investment and export growth, the Eurozone will find these factors less supportive as we go further into 2008. The combined effect of slowing world demand, a stronger euro and a scaling back of investment growth will impact upon Eurozone growth. Investment plans will be scaled back not only because of less positive prospects for demand, but also because banks will probably raise borrowing costs and tighten lending standards further as they seek to rebuild balance sheet positions.

The outlook for consumer spending is also worrying though the ECB has yet to recognise that the prospect of a rebound in domestic consumption looks less likely now. There are a numbers of factors stacked up against the consumer, not only the recent jump in inflation to a 14 year high as well as past interest rates rises but also the moderation in residential investment which is fully underway and likely to intensify in coming quarters. Surveys such as the European Commission's "Intention to make a Major Purchase" suggest that consumers are turning gloomier from rather average levels.

Chart 6: Consumer spending to remain weak – Major purchases intentions are falling - employment outlook poor – wage growth modest



Source: Thomson Datastream, European Commission

In the UK....

MPC expects to cut rates at a gradual pace

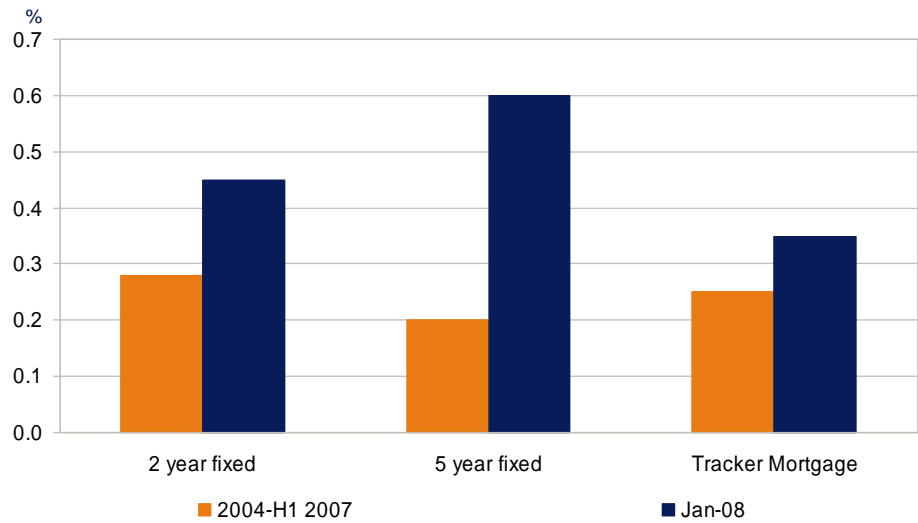
Recent data continues to highlight the two themes of downside growth risks and upside inflation risks, a combination typical of a maturing economic cycle but one that has been magnified, on the inflation front, by food and energy, and potentially by the significant drop in sterling on a trade weighted basis.

It is this policy dilemma that is likely to prevent the MPC (Monetary Policy Committee) from following in the Fed's footsteps and pursue more aggressive rate cuts, particularly when overall inflation in the UK could rise to 3%, prompting an explanatory letter from Mr King, the BoE governor, to the UK Chancellor during 2008.

Credit crunch hits the consumer

In recent weeks, more evidence has been emerging of the tighter lending standards imposed by lenders, particularly against those borrowers deemed to be at the riskier end of the spectrum. In Chart 7, the spread between riskier borrowers with a 95% LTV (loan to value ratio) and a less risky 75% LTVs has widened in January when compared to the average seen in the past 3 ½ years.

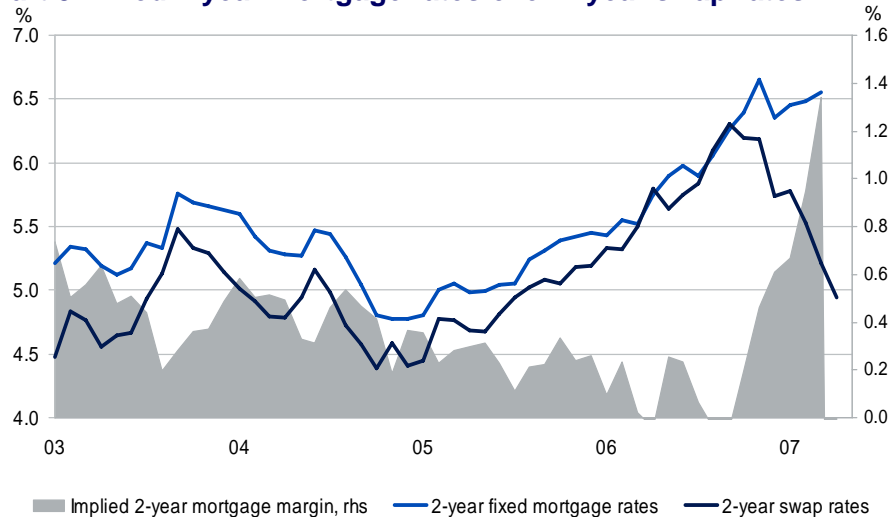
Chart 7: Spread between LTVs of 95% and less risky 75%



Source: Thomson Datastream, Bloomberg

Also, despite the 50bp rate cuts already instituted by the MPC these are not being passed on to mortgage holders, particularly those with 2-year fixed rate which represent roughly 75% of all mortgages issued in the UK. Given that 2-year swap rates, on which 2-year fixed rate mortgages are based, have fallen by more than 100bp since the middle of last year, it would appear that lenders are hoarding cash in order to rebuild their balance sheets, all of which implies that the consumer faces another headwind in 2008, which in a sense would require the MPC to undertake further cuts in order to make sure the cuts are reaching households.

Chart 8: Fixed 2-year mortgage rates over 2-year swap rates



Source: Thomson Datastream

But with inflation expectations at elevated levels the BoE would rather cut at a gradual pace, betting on growth slowing inflation, instead of quicker and deeper cuts which could lead to higher inflation and the Bank having to re-establish their inflation fighting credentials. The alternative scenario is that gradual cuts could present the risk of a more prolonged period of soft economic growth and falling interest rates. The MPC appears to be ruling out deeper cuts of 75bp-100bp expected by the markets but we believe that enduring weakness in economic activity will ultimately require the Bank to indeed cut rates by a further 75bp, in line with our forecast of year end rates of 4.50%.

Forecast Summary

I. Forecast summary

Real GDP

y/y%	Wt (%)	2005	2006	2007	2008	Consensus
US	32.7	3.1	2.9	2.2	2.1	1.6
UK	5.9	1.8	2.8	3.1	1.8	1.7
Eurozone	26.6	1.5	2.9	3.0	1.8	1.6
Japan	13.0	1.9	2.2	2.1	1.8	1.4
Australia**	1.6	2.8	2.7	4.1	3.3	3.5
OECD	79.8	2.3	2.8	2.6	2.0	1.6
China	5.8	10.4	10.7	11.4	10.5	10.3
Emerging*	20.2	6.6	7.3	7.1	6.9	6.6
World	100.0	3.1	3.7	3.5	3.0	2.6

Inflation CPI

y/y%	Wt (%)	2005	2006	2007	2008	Consensus
US	32.7	3.4	3.2	2.9	3.2	2.9
UK	5.9	1.9	2.7	2.3	2.0	2.4
Eurozone	26.6	2.2	2.1	2.1	2.4	2.5
Japan	13.0	0.0	0.1	0.1	0.3	0.5
Australia	1.6	2.7	3.5	2.3	2.6	3.3
OECD	79.8	2.3	2.3	2.1	2.4	2.3
China	5.8	1.8	1.5	4.8	4.5	4.5
Emerging*	20.2	4.6	4.5	5.1	5.0	5.0
World	100.0	2.8	2.8	2.7	2.9	2.9

* **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 (weights are at 2006 US\$).

Interest rates

%	Wt (%)	Dec-05	Dec-06	Dec-07	Dec-08	Market
US	32.7	4.25	5.25	4.25	2.00	2.38
UK	5.9	4.50	5.00	5.50	4.50	4.66
Eurozone	26.6	2.25	3.50	4.00	3.50	3.52
Japan	13.0	0.10	0.25	0.50	0.50	0.67
OECD	78.2	2.90	3.81	3.64	2.45	2.66

Market from forward futures strip as at 18/02/2008

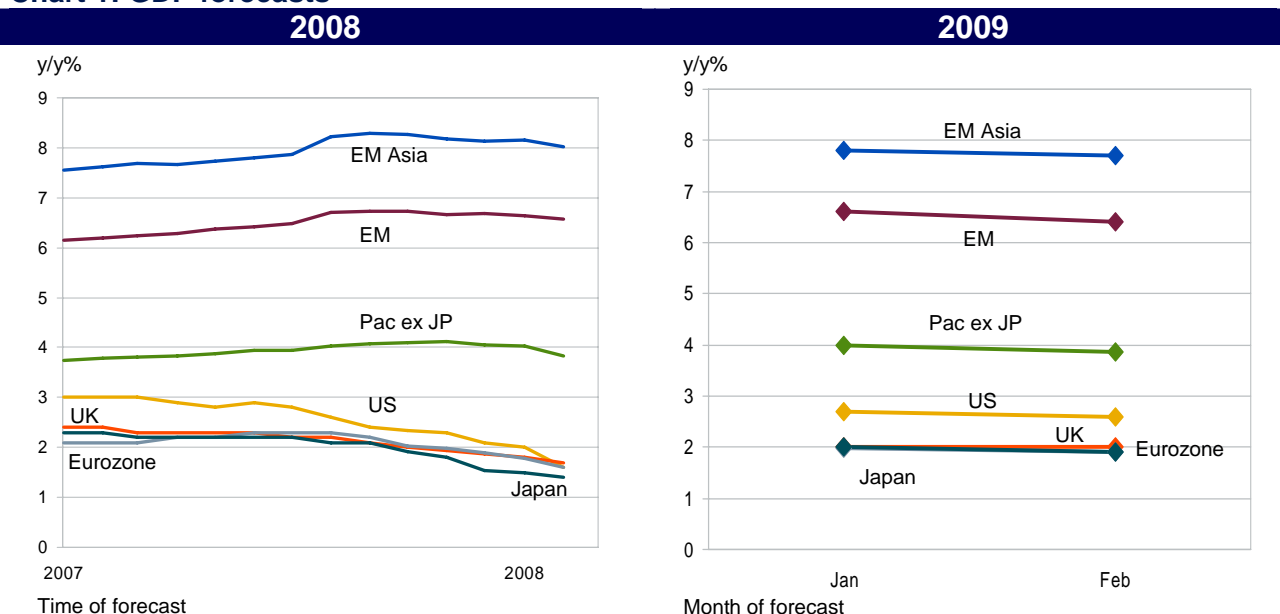
Key variables

FX	Current	Dec-06	Dec-07	y/y%	Dec-08	y/y%
USD/ GBP	1.95	1.96	2.10	7.0	1.88	-10.5
USD/ EUR	1.47	1.32	1.50	13.6	1.50	0.0
JPY/ USD	108.1	117.4	105.00	-10.6	105.70	0.7
GBP/ EUR	0.75	0.67	0.71	6.2	0.80	11.7
Brent crude	95.0	62.3	88.0	41.3	87.5	-0.6
US output gap %GDP	0.1	0.6	0.1		-1.1	
Unemploy. %	4.9	4.4	4.8		5.5	

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

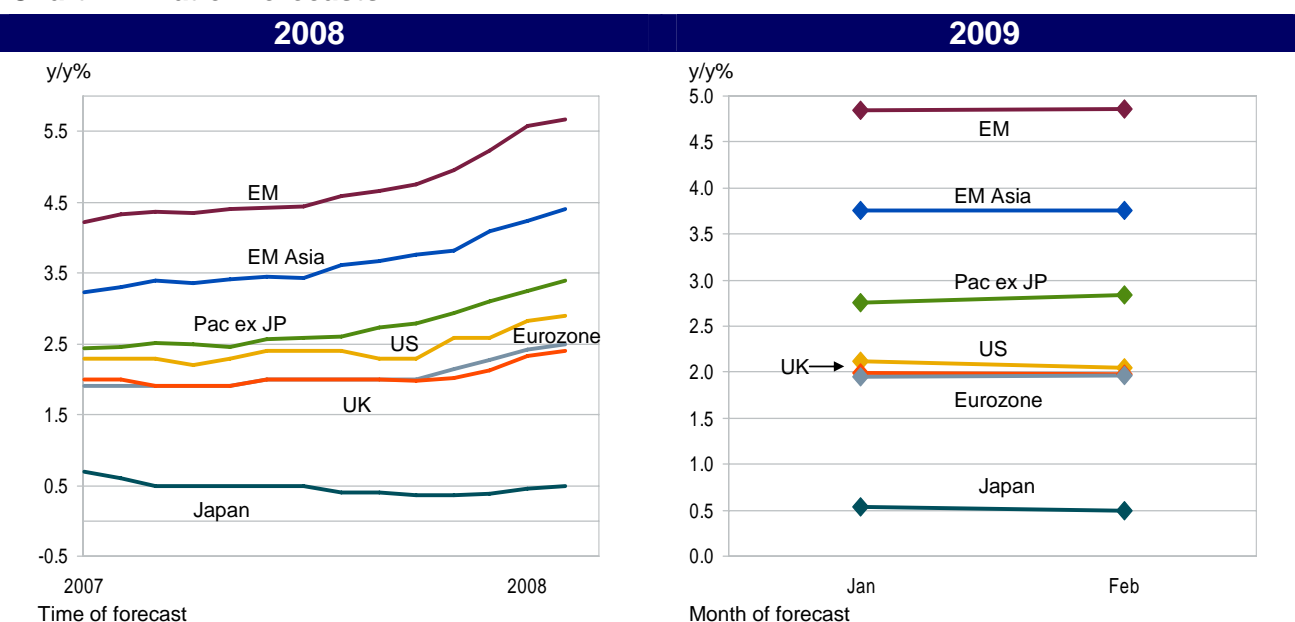
II. Updated forecast charts

Chart 1: GDP forecasts



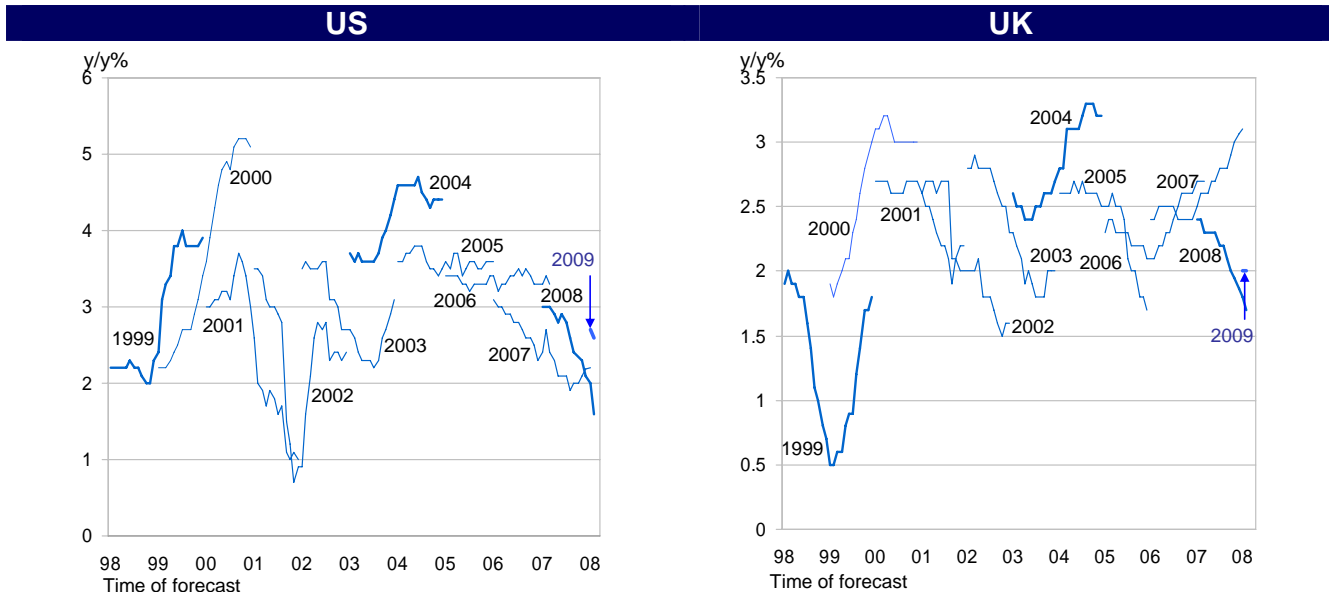
Source: Consensus Economics (Feb.), 2006 GDP weights, Schroders
 Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
 Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand
 Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, 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, Slovenia

Chart 2: Inflation forecasts



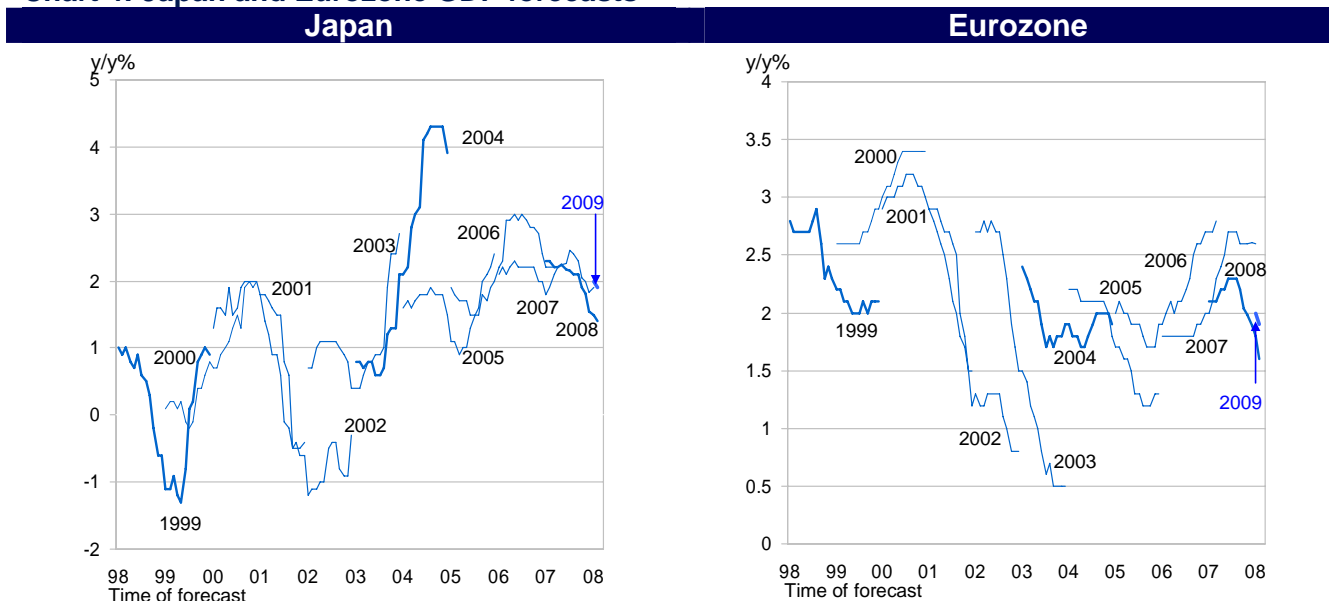
Source: Consensus Economics (Feb.), 2006 GDP weights, Schroders
 Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
 Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand
 Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, 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, Slovenia

Chart 3: US and UK GDP forecasts



Source: Consensus Economics (Feb.), Schroders

Chart 4: Japan and Eurozone GDP forecasts



Source: Consensus Economics (Feb.), Schroders

The views and forecasts contained herein are those of Schroders Investment Management's Economics Team, and do not necessarily represent Schroders Investment Management's house view.

This document does not constitute an offer to sell or any solicitation of any offer to buy securities or any other instrument described in this document. The information and opinions contained in this document have been obtained from sources we consider to be reliable. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that Schroders has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. For your security, communications may be taped or monitored.