

Schroder Private Banking Investment Outlook

Recovery at Risk

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We expect the economic recovery to continue. However, events on three continents have increased the risk of a double dip recession. An election defeat for the ruling Democratic Party in the US, a debt crisis in Greece and restrictions on bank lending in China have all contributed to increasing the odds on another economic downturn.

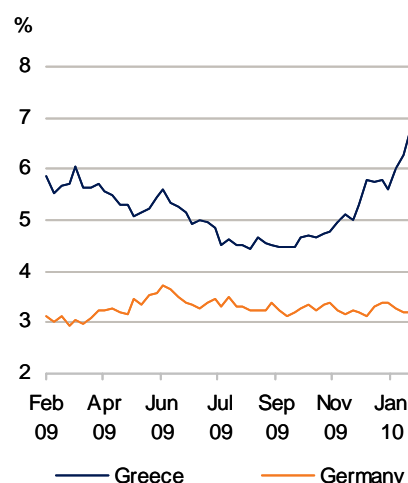
The surprising success of the Republican candidate in the Massachusetts senate election, a state that has had a Democrat senator since 1953, robs the ruling party of their filibuster-proof majority and spells an end to Obama's healthcare proposals. This marks a turning point in political agenda ahead of November's mid-term elections. In effect, the voters of Massachusetts have voted against big government and put a cap on government spending, effectively tightening fiscal policy.

The response of the Obama administration was to introduce the "Volcker Rule" three days later, which aims to restrict proprietary trading by banks. In addition, Obama talked about strengthening capital requirements and regulating derivatives trading. This is a concern on three fronts. First, these measures will increase the cost of capital for these activities. Second, attacking the banking sector is likely to make banks more reluctant to lend at a time when credit conditions are already tight. Finally, it appears that policy is being invented on the hoof, creating greater uncertainty and increasing the risk of policy error.

Greek bond yields spiked higher in January due to rising concerns

about the sustainability of its public finances (see Chart 1).

Budget crisis causes Greek bond yields to soar



Source: Bloomberg.

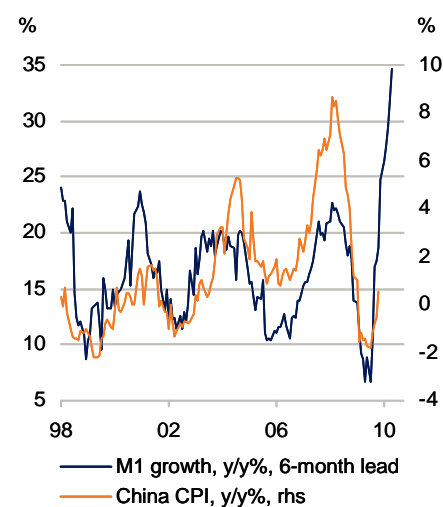
Past performance is not a guide to future performance.

Greece has a deficit of over 12% of GDP and borrowings exceeding 100% of GDP. The government needs to make substantial spending cuts but their proposals have led to government sector strikes, farmers blocking roads and students rioting on the streets. Still, if politicians prove unable to take sufficient measures to improve the outlook for public finances, markets will force the issue. In addition, Greece may well require assistance from the European Union.

But if a rise in bond yields from under 4.5% to over 7% is insufficient to persuade Greek farmers, students and public sector workers to accept we live in tougher times, what will it take to persuade politicians in Germany that they need to fund some form of bailout? This crisis has further to run.

The story in China is more straightforward. Last year's measures to revitalise the economy have been successful. The manufacturing sector is operating close to its potential. Meanwhile rapid money growth raises the risks of inflation (see Chart 2).

Money growth points to higher inflation in China



Source: Thomson Datastream, Markit, Schroders, 11 January 2010



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Rapidly rising property prices have led to the government targeting speculation. The authorities have put the brakes on bank lending growth and further tightening measures are expected.

The exit strategy from the policies of 2009 was always going to be a challenge for markets in 2010. The fact that a number of emergency measures enacted last year will not be repeated mean that both fiscal and monetary policy will be a lot less stimulative this year. This week's events seem to have swung the odds in favour of lower fiscal spend and greater political uncertainty. In addition, global money growth has been shrinking since October. This has been a precursor of many financial crises

(albeit not always on the scale and breadth of the most recent experience).

January saw a rally in the dollar against the euro, a decline in equities, underperformance of emerging market equities relative to developed markets and a widening in the spread between corporate bonds and government bonds.

While the events above point towards a more defensive strategy, it is no longer entirely obvious what a defensive investment is. Greek bonds clearly do not fall into the category. Are UK gilts any safer? Our overriding concern over the medium-term view is that current fiscal policies

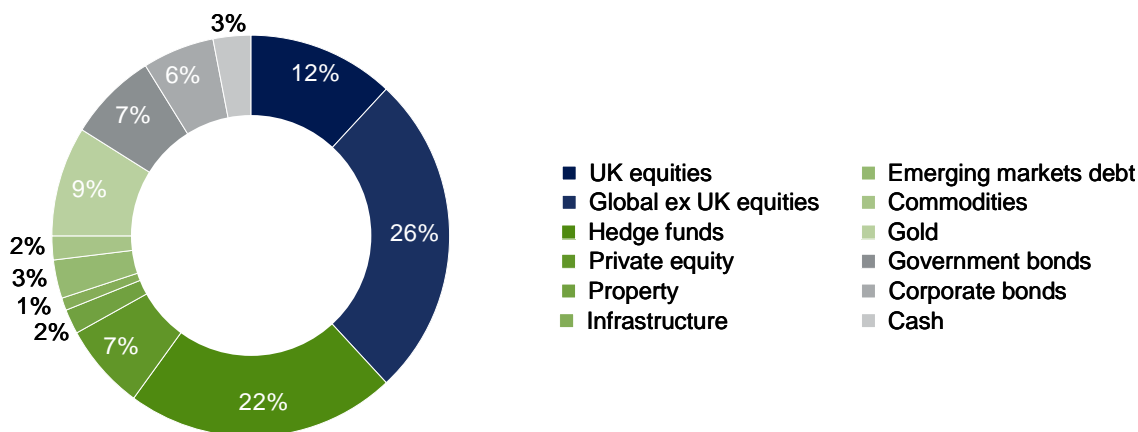
are unsustainable across developed economies.

For clients with genuine long-term horizons, this makes equities a safer bet than government bonds.

However, the current environment remains deflationary and U.S. Treasuries and German Bunds retain appeal in this environment.

For our balanced and growth portfolios we are maintaining current positions. For more risk averse portfolios, we are taking a more defensive stance.

Asset allocation for balanced mandate



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