

# Schroders

## Economic and Strategy Viewpoint

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### Global: Assessing the oil shock

- Oil shocks have a strong hold on the popular imagination, a consequence of their close association with stagflation and recessions (see chart). The latest, driven by a combination of economic recovery and political unrest in the Middle East and North Africa, is less likely to send the world economy back into recession.
- The increase in energy prices has been smaller, part of it reflects the buoyancy of activity and energy intensity continues to decline. We would need to see prices rise toward \$150/ barrel or central banks like the US Federal Reserve take a more hawkish line (like the ECB) for us to become concerned about a double dip.

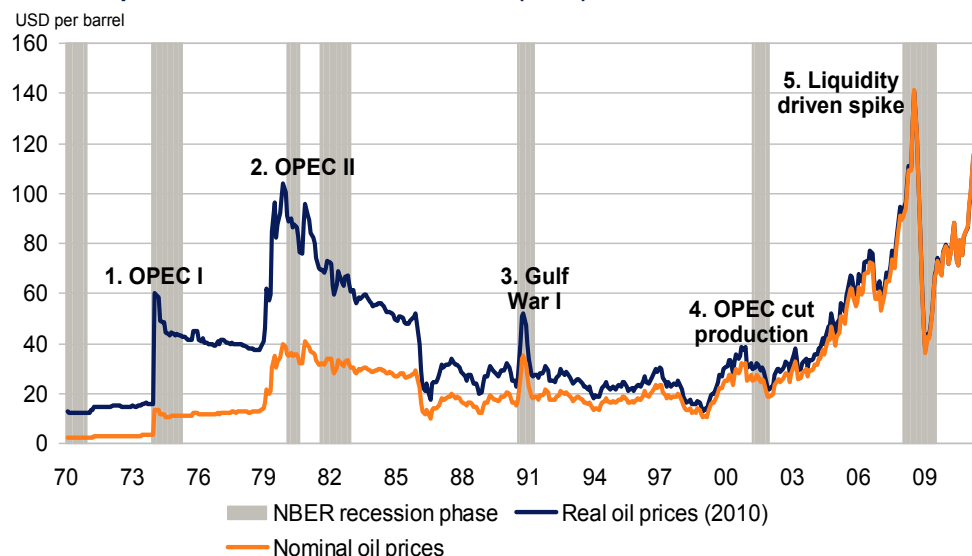
### Japanese earthquake: Exposing the fault lines

- We have cut our forecast for Japanese GDP growth this year as a consequence of the earthquake and tsunami which hit on March 11. However, the downside impact should be short lived and we have revised up our forecast for 2012 as the economy should recover strongly as reconstruction gets underway – a V-shape profile for GDP. The risk at this point is that ongoing fear of radiation leaks and power cuts delay the return to growth.
- For the rest of the world, the greatest risk relates to Japan as a provider of capital, rather than a source of demand. Japan maybe the world's third largest economy, but being export led is dependent on the rest of the world rather than vice-versa. Instead it is the potential disruption to capital flows from Japan which could be disruptive for markets like US Treasury bonds. The ability of the G7 to stabilise the currency is critical in this respect.

### Europe: Forecast update

- Forecast changes for growth are mixed in Europe with upgrades for northern Europe, but downgrades for debt ridden southern Europe. However, inflation has been revised up across the region as higher oil prices begin to feed through to general inflation. Meanwhile, the ECB has clearly signalled that interest rate rises are imminent, and we have incorporated a tighter policy stance into the forecast.
- There are three risks to our forecast. The first is another blow-up in the sovereign debt crisis which remains unresolved. The second is Japan, though we are confident the impact on Europe will be limited. Finally, oil prices again, though the risks are both on the upside and downside.

### Chart: Oil prices in nominal and real terms (2010)



Source: Thomson Datastream, NBER (National bureau of Economic Research), Schroders, 28 March 2011.



# Global

## Global: oil shocks and earthquakes

This month we include our quarterly update of our forecasts for global growth and inflation. For the first time in two years, we are not revising up our growth projection for the current year which remains at 3.5% for 2011, an indication that much of the good news on the economy may now have come through. Our view that the world economy is on a sustainable footing has become more widely accepted and fears of a double dip, which held sway in the middle of last year, have faded considerably.

**Higher oil prices have prevented us from upgrading global growth**

Having said that, had it not been for the rise in oil prices we would have increased our growth forecasts to reflect the continued strength in indicators such as the Purchasing Managers' indices. Instead, we are revising up our inflation forecasts for 2011 from 2.5% to 3.5% to reflect the increase in oil and food prices over the past three months. This will cut into real income growth and consumer spending offsetting much of the improvement in business indicators.

### Assessing the oil shock

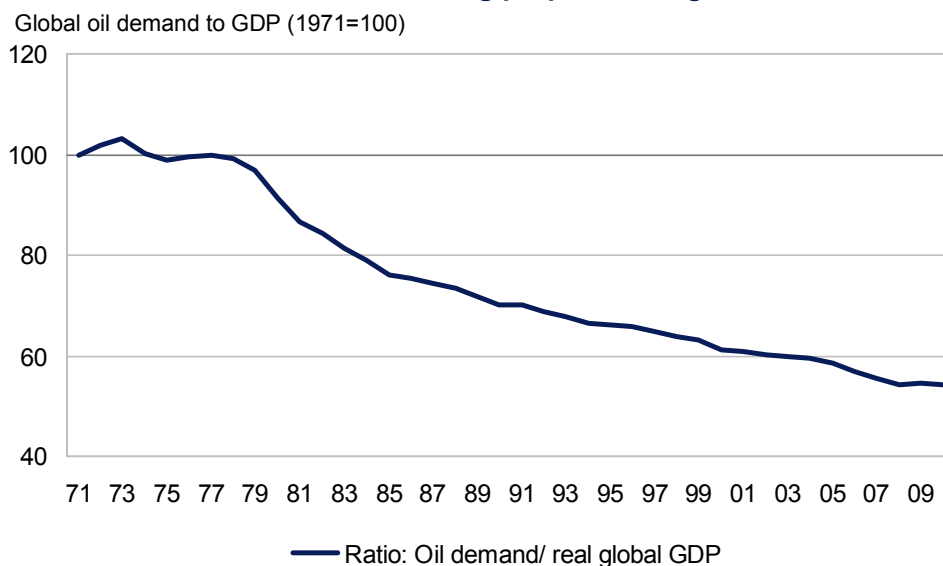
A key judgement in our forecast is that the rise in oil and commodity prices is not sufficient to derail the recovery. Much has been made of the strong correlation between oil price shocks and activity with recession closely following higher energy costs on five occasions since 1970 (see chart front page).

**Oil shocks have had a grip on the popular imagination since the 1970s**

Oil shocks have had a strong hold on the economic psyche since the 1970s when cuts in production by OPEC led to the malaise of stagflation. Memories of high unemployment and soaring inflation persist, but the world economy, along with many other things, has changed considerably since then with the energy intensity of GDP having fallen significantly. Those first shocks destroyed capacity and led to the drive toward energy efficiency. Consequently, oil now has less power to shock: whilst global GDP has more than tripled in real terms since 1971, oil demand has less than doubled. The ratio of demand to GDP has nearly halved as a result (see chart 1). Note that this trend has not been noticeably altered by the rise of the more energy intensive emerging economics which are included in our estimates.

**But energy intensity has fallen**

**Chart 1: Oil demand has been a falling proportion of global GDP**



Source: Thomson Datastream, Schroders, 28 March 2011

In terms of the current shock, we would also note that the rise in oil prices over the past year is less than on each of the five previous occasions which led to recession. On our calculations, prices have risen around 60% during the current episode compared with an average of 174% in the past (see table 1).

**Table 1: Oil shocks compared**

*This shock is also less severe...*

Period	Oil price: % peak to trough		Duration	1 year after peak v.trough
	Nominal	Real		
<b>Dec-73 to Jan-74</b>	293%	286%	1 month	179%
<b>Nov-78 to Nov-79</b>	201%	170%	12 months	170%
<b>Jun-90 to Oct-90</b>	133%	128%	4 months	-40%
<b>Mar-99 to Nov-00</b>	151%	142%	20 months	138%
<b>Jul-07 to Jul-08</b>	92%	83%	12 months	-10%
<b>Jul-10 to Mar-11</b>	60%	58%	8 months	?

Source: Thompson Datastream, Schroders

*...and is partly driven by demand*

Furthermore, although the last \$25 of the rise in oil prices has been linked to the crisis in the Middle East and North Africa (MENA), prior to that rising demand in Asia and the US has driven prices. The distinction is important as demand driven increases in energy costs are indicative of stronger global activity whereas supply driven shocks have no offsetting demand boost. Consequently, the stagflationary impact of supply shocks is greater.

On balance this leaves us reasonably confident that the latest oil shock will not undermine our baseline forecast, but with two caveats. First, that we do not see disruption spread to Saudi Arabia and the oil price spike higher toward \$150 and beyond. Second, that central banks continue to look through the shock and refrain from tightening. The US Federal Reserve and Bank of England are playing along, but unfortunately it looks like the European Central bank (ECB) will not do so as Monsieur Trichet looks set to raise rates in response to higher headline inflation. We have incorporated a tighter stance from the ECB as a result (see below for more discussion).

### Japanese earthquake: exposing the fault lines

*The recent earthquake and tsunami in Japan were a terrible reminder of the power of nature and our sympathies are with those directly affected. At the time of writing, the first estimates of the costs of the damage are coming in whilst the authorities are still struggling to stabilise the Fukushima nuclear power plant. Recognising that there is scope for the situation to deteriorate we put forward our analysis of the impact of the disaster.*

*Japanese economy to follow V-shape post earthquake*

There is a consensus building amongst economists that the negative impact on GDP growth will be relatively short lived with the economy expected to follow a V-shape path: a sharp fall in GDP over the next quarter, followed by a rebound as reconstruction work begins. The authorities are lining up a fiscal package of between ¥5 and ¥10 trillion (1–2% GDP) which will kick start a massive reconstruction process. Estimates of the cost of rebuilding have been put at as much as ¥25 trillion (\$312bn), around 6% of GDP, indicating that the recovery could be a multi-year process. We are cutting our forecast for Japanese GDP growth this year to 0.8% from 1.2% and raising the figure for 2012 to 2.4% from 2.0%. The loss of activity is made up as reconstruction boosts GDP.

**Although the nuclear situation could turn this into a U shape.**

The risks to this view largely depend on developments at Fukushima, as an escalation in the nuclear crisis would deepen the downturn (as people stay indoors rather than go out spending) and delay the recovery as concerns about radiation hamper rebuilding. Widespread power cuts would also slow the upturn. In this respect, the current crisis may be different from that of Kobe in 1995, where reconstruction after the earthquake was able to begin relatively rapidly.

**Japan is not a driver of global growth**

From the perspective of the rest of the world, the fall off in demand will initially hit exports into Japan, before a recovery sets in. Japan accounts for around 9% of global GDP, but overall we would not look for a significant effect on activity, as the world's third largest economy does not play a major role in driving demand. As Japanese consumer spending has been in the doldrums for the past decade, domestic demand has been weak and growth has been largely dependent on exports. Japan is dependent on the rest of the world rather than *vice versa*.

There will be some disruption to supply chains, particularly in the car and IT sectors, but these are not expected to be long lasting when, at a time of excess capacity, there are plenty of alternative suppliers. Note that Japan's exports of components are relatively limited, accounting for just 13.5% of total exports.

**Impact on capital flows: The Yen, the Nikkei and US Treasury bonds**

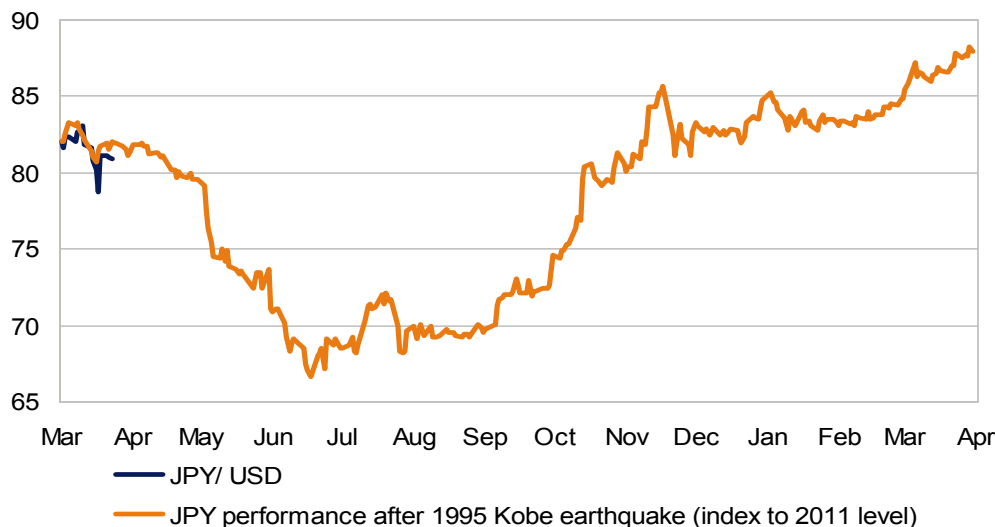
**The Yen rose sharply after the Kobe 'quake...**

The main global effect of the crisis has been felt in currency markets where the Yen initially rose strongly in the wake of the disaster, hitting a record high of 76.25 on March 16<sup>th</sup>. It looked as though history was repeating itself as one of the features of the post-Kobe earthquake experience was a sharp rise in the Japanese Yen. This time, however, co-ordinated intervention in the foreign exchange market by the G7 reversed the gain and stabilised the currency.

Back in 1995, the move in the Yen was driven by anticipation of significant inflows from insurance companies meeting earthquake related claims. There is some debate as to whether such flows actually materialised, but the data does show a reduction in outflows by Japanese savers during the period, indicating a desire to keep funds at home to meet crisis related spending. Given the importance of the carry trade (cash trades that take advantage of interest rate differentials) as an offsetting outflow to the current account surplus, this supported the Yen which rose some 20% against the dollar in the first four months of 1995 (see chart 2).

**...as Japanese savers kept money at home**

**Chart 2: Japanese Yen performance compared : today versus 1995**



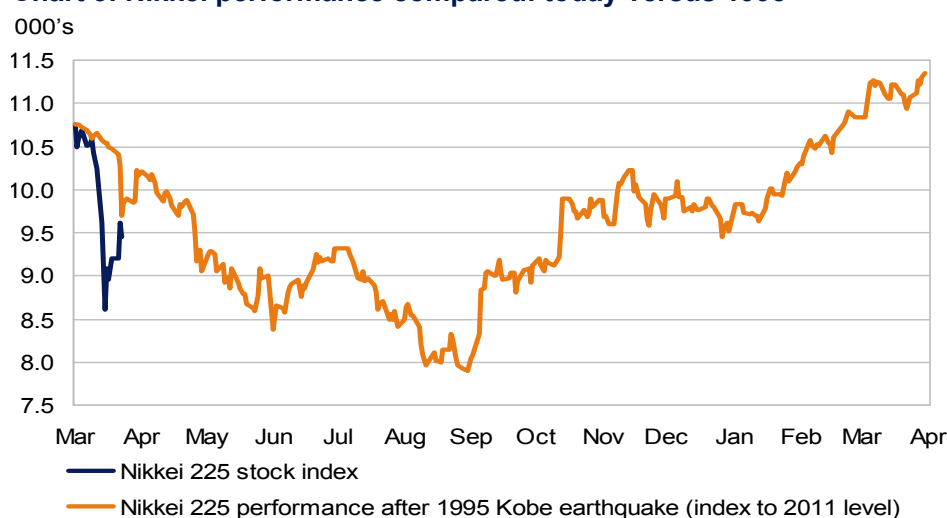
Source: Thomson Datastream, Schroders, 23 March 2011

**Rising Yen would undermine Japanese equities**

Whether foreign exchange intervention can continue to hold the Yen in the face of this force is important for both Japanese and international financial markets. There is a strong case for Japanese equities on valuation grounds at present with the main indices falling sharply in the wake of the earthquake. So far the decline has been greater than at the same point 16 years ago (chart 3). Such a reaction may reflect the tail risk associated with a potential nuclear disaster, but it looks overdone, particularly in light of the fact that the market is much better value today, trading on a price to book ratio of 1.1 compared to 2.5 in 1995.

The latest data shows that international investors continue to buy the market but the case for Japanese equities would be weakened by an appreciating Yen which acts as a headwind on the export orientated market. This was the pattern in 1995 as the stronger Yen first pushed down the Nikkei before depreciating and helping to drive the market higher. One year later the Nikkei had regained all its losses and some. However, even with this recovery, in relative terms there was a significant underperformance compared to the S&P500 which rose 34% in 1995.

**Chart 3: Nikkei performance compared: today versus 1995**



Source: Thomson Datastream, Schroders, 23 March 2011

**Japanese investors are also active investors in the US Treasury market**

Looking more broadly, Japan is a significant international investor as reflected in its persistent current account surplus. Purchases of US Treasury bonds account for a significant part of Japan's international investment, some ¥13.7 trillion net (\$171bn at current exchange rates) in 2010 according to the Ministry of Finance. That represented a significant contribution to funding the \$1.29 trillion US budget deficit in fiscal year 2010. Japanese investors are also active in carry trades to higher yielding markets such as Australia and Brazil.

Consequently, should investors decide to stay at home and concentrate on funding the reconstruction effort, rather than buy overseas bonds, we could see upward pressure on global yields. That would represent a tightening of policy, putting pressure on consumers, the housing market and the banking sectors. Such an outcome would then knock on effects to global risk assets should investors began to fear for the US recovery.

**A stable Yen is important for the smooth flow of international capital**

The key is the Yen. The G7 generously responded to the rise in the Japanese currency to assist Japan in a time of need. Such a move could also be seen in a more selfish light: by keeping the Yen stable, the G7 are encouraging Japanese investors to maintain the smooth flow of capital from Japan to the rest of the world.



# Europe

## Europe: Forecast update

A number of events have taken place over the past few months which have affected our economic forecast to varying degrees. European economies appear to have built up sufficient momentum to maintain activity levels close to record highs, though some growth has been lost to higher inflation.

### Growth & inflation

Recent surveys suggest levels of activity in Europe have been mixed over the past quarter. In northern mainland Europe, the export orientated economies have managed to maintain solid momentum, particularly Germany. However, activity in southern Europe continues to struggle to make significant gains, as the adverse impact from fiscal consolidation intensifies.

At the same time, the recent spike up in the price of oil in reaction to the tensions in the Middle East and North Africa region is likely to worsen the trade off between real growth and inflation across Europe over the coming year.

Table 2 gives a summary of our latest growth and inflation forecasts and how they have changed in the last quarter. The inflation forecast for the entire region has been raised mainly due to the rise in the price of oil. Note that as we assume oil will fall back slightly in the coming years, the level shift in the price of oil only causes a temporary rise in inflation. We expect inflation across the region falls back in 2012.

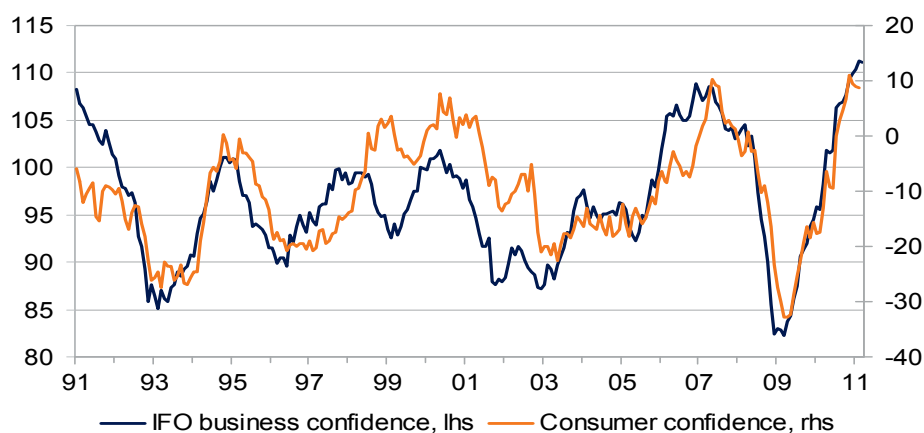
**Table 2: Summary of European growth & inflation forecast changes**

	2011				2012			
	Growth		Inflation		Growth		Inflation	
	New	Prev.	New	Prev.	New	Prev.	New	Prev.
Eurozone	1.5	1.6	2.0	1.6	1.7	1.8	1.2	0.9
Germany	2.7	2.6	2.0	1.7	2.1	2.3	1.4	1.0
France	1.5	1.3	1.8	1.5	1.8	1.6	1.3	1.1
Spain	0.1	0.2	2.4	2.1	0.8	0.9	0.9	0.7
Italy	1.0	1.6	2.0	1.5	1.5	0.9	1.1	1.0
UK	1.8	2.3	4.1	3.4	1.6	1.7	2.0	2.2

Source: Schroders. Updated: 22 March 2011.

Meanwhile, we have revised up growth for Germany and France, but revised down growth for Italy, Spain and the UK. In Germany, in the face of higher commodity prices, and the disaster in Japan, both the IFO's business confidence survey and the European Commission's consumer confidence survey continue to print near record levels (chart 4).

**Chart 4: German business and consumer confidence**



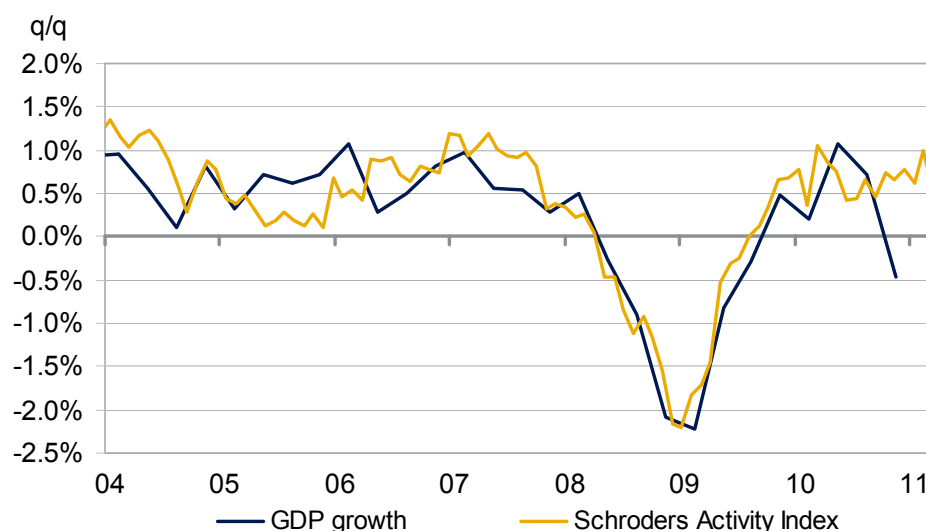
Source: Thompson Datastream. Updated 28 March 2011.

*...but upgrades for Germany and France as activity and confidence continue at close to record highs*

**A surprise Q4 contraction in UK GDP is the cause for the 2011 GDP forecast downgrade**

In the UK, the large downward revision to the 2011 annual growth forecast is almost entirely due to the disappointing contraction in real GDP in the fourth quarter of last year. The Office for National Statistics (ONS) estimates real GDP to have contracted by 0.5% in the fourth quarter, though it estimates without the effect of heavy snow in December, economic growth would have been flat. The main reason why the Q4 contraction took many by surprise was the still robust signal that was being reported by private business surveys. Our Schrodgers Activity Index had suggested a slowdown to about 0.4% growth (see chart 5).

**Chart 5: UK GDP growth vs. Schrodgers Activity Index**



Source: Thompson Datastream, Schrodgers. Updated 29 March 2011.

**Though even when we exclude the snow effect in Q4, the UK economy is going through a soft patch...**

Looking ahead, if the ONS is correct with its estimate, then we would expect to see a reversal of the snow effect in the first quarter of this year. At the moment, we expect Q1 GDP to grow by 0.7%, although even excluding the impact of the snow disruption, 0.2% growth over the last two quarters can only be described as weak.

The soft economic data presented a challenge for the UK Chancellor George Osborne who presented his second budget earlier this month. Having previously announced all of the painful austerity measures, he decided to focus on measures to boost growth. Overall, the change in fiscal policy was minor and made little difference to our forecast.<sup>1</sup>

### Monetary policy

**The ECB send out a clear signal that interest rates are set to rise...**

Last month, President of the European Central Bank Jean-Claude Trichet gave his strongest signal to date that the ECB was very close to raising interest rates. In his opening statement, monsieur Trichet opted to abandon what had become his catch-phrase of late: *"monetary policy is appropriate"*, and instead replace it with *"strong vigilance is warranted"* - a phrase synonymous with an imminent increase in interest rates as had been the case in 2005, 2006 and 2007.

In fact, the signal was even stronger. The first question during the question and answer session asked about the change in language. He replied: *"We mentioned that we are being very vigilant and my understanding of the position of the Governing Council – fully in line with assessments made in the past - is that an increase in interest rates at the next meeting is possible."* A clear message that the Governing Council is on the cusp of raising interest rates.

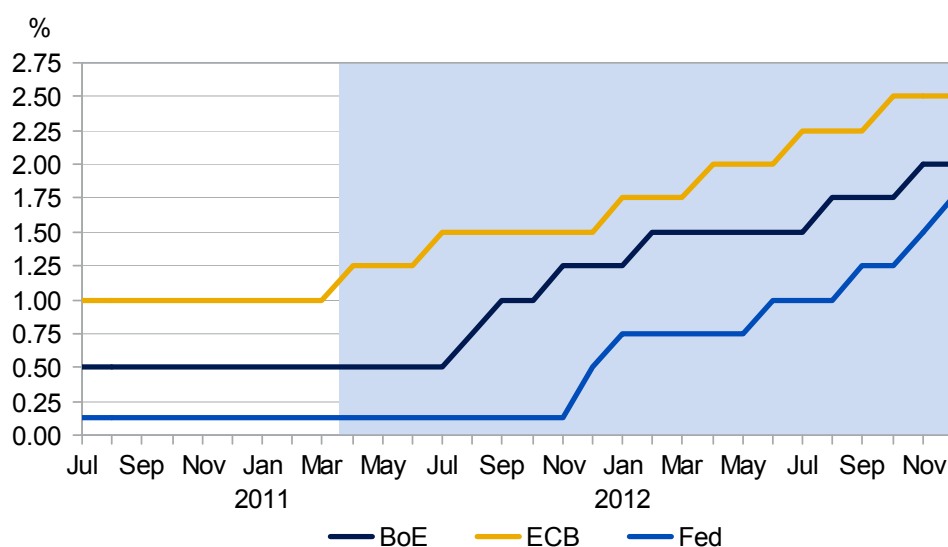
<sup>1</sup> For more detailed analysis, see the Talking Point piece: *"Budget 2011: Plan A still on track"*.

As a result, we have brought forward our forecasted first rise in the ECB's policy interest rate to April in line with Trichet's signal, and expect one further rate rise this year.

***This is likely to be the start of the ECB's rate hiking cycle, but it will not want to raise rates much faster than the Fed & BoE***

This is probably set to be the start of the ECB's rate hiking cycle, but with the FED likely to keep interest rates on hold until the end of the year and the Bank of England still biased towards holding rates for longer, the ECB is likely to be limited in how far it can raise its own rates (Chart 8 shows our forecast for the FED, ECB and BoE interest rates profile). If the ECB raises much faster than we are forecasting, then we would expect the Euro to strengthen significantly against most other major currencies, which in itself would act to slow growth. The Euro has already risen 1.3% on a trade weighted basis since the ECB's press conference and change in language.<sup>2</sup>

**Chart 8: Schrodgers policy interest rates forecast**



Source: Thompson Datastream. Updated 22 March 2011.

***Many have criticised the ECB for focusing too much on headline inflation, which is rising due to higher food and energy prices...***

Though criticised by many for focusing too much on headline inflation and not on the temporary nature of the recent energy and food price inflation (See January Economic & Strategy Viewpoint), there have been some indications that some European countries may require monetary tightening sooner rather than later.

Chart 6 (next page) shows ECB interest rates plotted against the Eurozone aggregate measure of capacity utilisation. As the chart shows, ECB interest rates are closely correlated with the measure of spare capacity. Using this measure, only Austria of the largest 6 nations (as shown by the swathe) has capacity utilisation above its long-run average. Germany has the second highest measure, but if the ECB is focusing on the Eurozone aggregate, then it should still be some months away from a change in monetary policy.

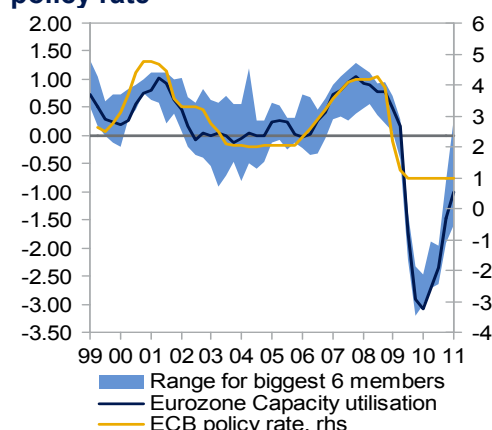
On the other hand, chart 7 (next page) shows how survey data on employment intentions tends to lead ECB rate cycle. As the chart shows, all of the 6 largest Eurozone economies have above long-run average readings - indicating a healthy demand for labour going forward. Indeed, by this measure, interest rates do seem inappropriately low.

<sup>2</sup> Using the Bank of England's series and taking the change between the 3<sup>rd</sup> and the 28<sup>th</sup> of March.

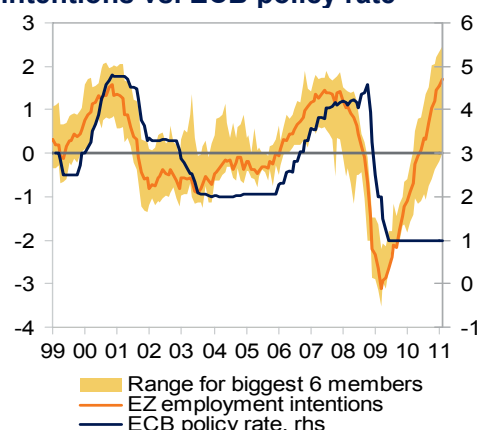


*...though leading indicators such as employment intentions suggest interest rates are not appropriate*

**Chart 6: Capacity utilisation vs. ECB policy rate**



**Chart 7: Standardised employment intentions vs. ECB policy rate**



Source: Thompson Datastream, European Commission. Updated: 28 March 2010.

In any case, the effect of bringing forward our interest rate profile does have some impact on Eurozone inflation, but only a marginal one. Had we not changed the profile, we expect inflation would be 2.2% in 2011 and 1.3% in 2012, versus our new forecast of 2% and 1.2% in 2011 and 2012.

As for the Bank of England, we expect the Monetary Policy Committee (MPC) to not only wait until there is evidence that the recent slowdown in growth is temporary, but also to be able to examine the impact of the coming increase in National Insurance contributions (payrolls tax). This means that the MPC is unlikely to move on interest rates until after the August Inflation Report at the earliest.<sup>3</sup>

### Forecast risks

The first section of this note explores a number of the major risks in more detail. As far as we can see, the largest three risks to our European forecast are:

1. The sovereign debt crisis
2. Oil prices & MENA tensions
3. The crisis in Japan

*There is still a risk that the Eurozone sovereign debt crisis blows up again...*

Starting at the top of the list, Eurozone leaders took markets by surprise on March the 11th by announcing an agreement in principle to boost the effective lending capacity of the European Financial Stability Fund (EFSF) back to €440bn. In addition, lending conditions were relaxed for Greece, though Ireland could not agree a similar deal due to its reluctance to discuss tax harmonisation.<sup>4</sup> More recently, the European Council meeting held on the 25<sup>th</sup> and 26<sup>th</sup> failed to finalise the details of the EFSF, which will now be discussed further at the next meeting in June. Unsurprisingly, the absence of distress in risk markets and with the Euro appreciating, Eurozone leaders were in no rush to agree further help.

At the same time, José Sócrates resigned from his position as Prime Minister of Portugal as his minority government failed to gather support to vote through new austerity measures. The collapse of the government in Portugal means that it is unlikely to be able to negotiate an agreement with the Eurozone and IMF for a bailout. Portuguese and European officials continue to deny Portugal's imminent bailout, though with the yield on its 10 year bond now at 7.4%, and with Greece borrowing at an average rate of about 4.5%, it makes little sense to hold back.

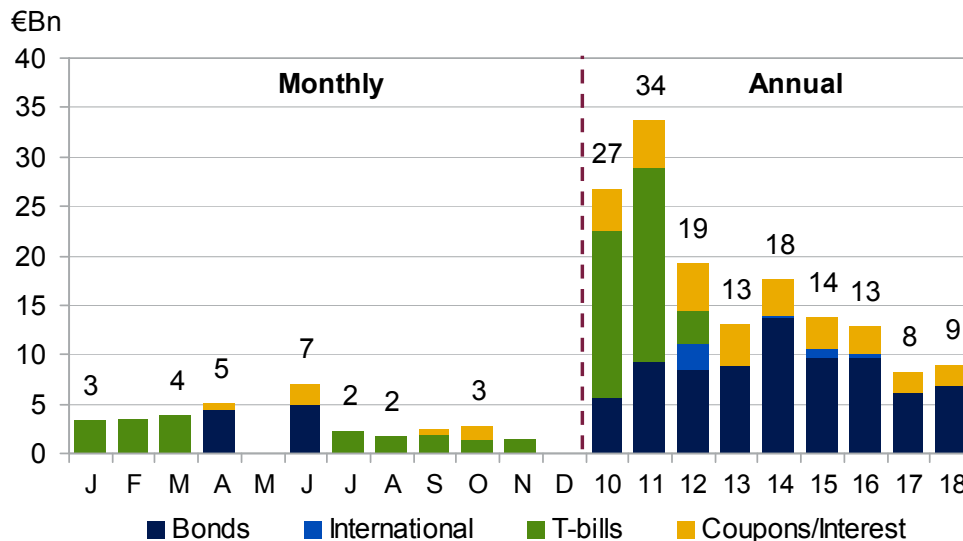
<sup>3</sup> For more detailed analysis, see the Talking Point piece: "The changing tide of UK monetary policy".

<sup>4</sup> For more detail, see the Quickview piece: "European debt crisis – just a bigger plaster"

**...with no government to negotiate a bailout, Portugal must re-finance €12bn of debt by June.**

Portugal has approximately €12bn of debt that is maturing in April and June, and may have to borrow more to fund its current deficit (see chart 9). Should the market close itself off to Portugal as it did with Greece and Ireland, then Portugal may have to arrange a bridging loan or credit facility to allow time for a new government to be formed (elections likely to be held likely in May or June), and for an EU/IMF package to be negotiated. This should not be a problem and so there is little risk of seeing an actual default in the coming months.

**Chart 9: Portuguese debt maturity schedule**



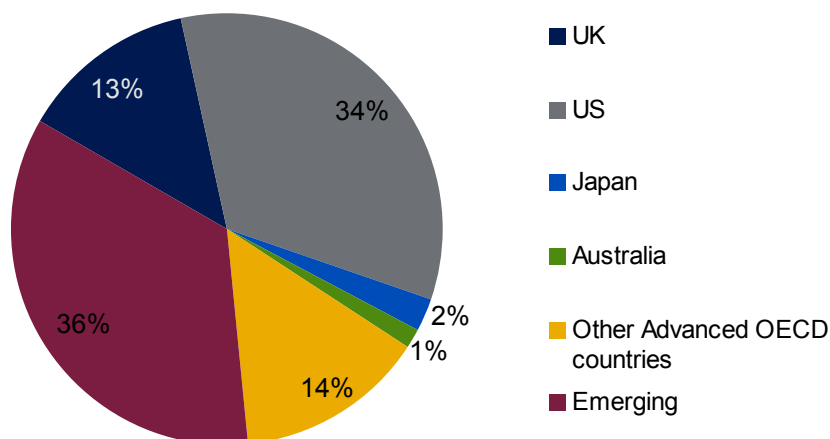
Source: Bloomberg, Schroders. Updated: 2 March 2011.

Moving on to Japan, as mentioned at the start of this note, Japan is not a significant importer of manufactured goods from the rest of the world. In terms of trade exposure, the Eurozone plus Euro pegged countries export approximately 2% of their total extra-Eurozone exports to Japan (see chart 10). In fact, the total hit to exporters will be even smaller as 54% of the region's exports are intra-Eurozone. Therefore, less than 1% of the regions exports actually go to Japan.

**Chart 10: European trade exposure to Japan**

**Only 2% of total Eurozone exports go to Japan.**

Eurozone and Euro Pegged countries exports to:



Source: Thomson Datastream. Updated 22 March 2011.

There may be an impact for some manufacturers who rely on parts from Japan as part of a wider production process, but such evidence is hard to find and is likely to be anecdotal.

***The wider risk of events in Japan is to supply chains, and the potential disruption of the long-term shift towards nuclear energy.***

Where there has certainly been damage done is towards the reputation of nuclear energy. At a time when many European nations are considering how to invest for future power generation, the crisis at the Fukushima nuclear power plant has prompted protests against the use of nuclear energy. The German coalition government has decided to delay a decision on whether to extend the life of 17 aging nuclear power plants. Days later, Chancellor Angela Merkel announced the closure of 7 plants for immediate safety checks.

Though the reaction is likely to be nothing more than short-term panic in reaction to events in Japan, there is a risk that countries across the world opt to increase their reliance on fossil fuels, potentially providing further support for higher oil prices.

***Finally, oil prices present a risk to our forecast, but it does so should prices rise much further, or should they fall sharply.***

This brings us to the third risk - oil prices. It is almost impossible to forecast with any real degree of accuracy how oil prices will move, especially when the moves are in reaction to geo-political events. The first section of this note explains why in our judgement, the recent rise in energy prices will not derail the recovery. However, there is a risk that oil price rise further, in which case we would be looking at a more stagflationary environment. Conversely, there is a risk that oil prices could fall back below \$100 per barrel. In this scenario, we could see the risk of deflation quickly re-emerging in the Eurozone, especially as core inflation remains low.

## I. Forecast summary

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	2.8	3.3	3.2	3.2	3.3
UK	4.1	1.4	1.8	2.1	1.6	2.1
Eurozone	23.5	1.7	1.5	1.5	1.7	1.6
Japan	9.5	4.0	0.8	1.2	2.4	2.0
Australia	1.9	3.0	3.2	3.1	3.5	3.5
OECD	65.4	2.5	2.2	2.2	2.4	2.4
China	9.1	10.4	9.0	9.2	8.5	8.9
Emerging*	34.6	7.3	6.0	6.2	5.5	6.2
World	100.0	4.2	3.5	3.6	3.5	3.7

## Inflation CPI

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	1.6	1.7	1.7	1.1	1.8
UK	4.1	3.3	4.1	3.3	2.0	2.0
Eurozone	23.5	1.6	2.0	1.8	1.2	1.7
Japan	9.5	-1.0	-0.3	-0.3	-0.2	0.0
Australia	1.9	2.9	3.0	3.0	3.0	3.0
OECD	65.4	1.4	1.7	1.6	1.1	1.6
China	9.1	3.3	3.2	4.3	3.0	3.6
Emerging*	34.6	5.2	7.0	5.7	5.5	5.1
World	100.0	2.7	3.5	3.0	2.6	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, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

## Interest rates

%	Wt (%)	Dec-10	Dec-11	Market	Dec-12	Market
US	26.4	0.25	0.50	0.78	1.75	2.24
UK	4.1	0.50	1.25	1.76	2.00	2.83
Eurozone	23.5	1.00	1.50	1.97	2.50	2.61
Japan	9.5	0.10	0.10	0.36	0.25	0.50
OECD	63.5	0.52	0.86	1.22	1.82	2.16

Market data as at

23/02/2011

## Key variables

FX	Current	Dec-10	Dec-11	y/y%	Dec-12	y/y%
USD/ GBP	1.61	1.60	1.60	0.0	1.60	0.0
USD/ EUR	1.37	1.34	1.30	-3.0	1.25	-3.8
JPY/ USD	81.7	83.0	86.0	3.6	90.0	4.7
GBP/ EUR	0.85	0.84	0.81	-3.0	0.78	-3.8
Brent crude	110.6	87.2	111.1	27.4	108.1	-2.7
US output gap %GDP	-6.5	-6.5	-4.0		-2.7	
Unemploy. %	9.6	9.6	8.1		7.6	

Source: Schroders, Datastream, IMF, Consensus Economics, March 2011

Note: 2010 EM GDP based on IMF forecasts

## Steady Growth, temporary effect from oil

● We continue to forecast a recovery for the world economy with a slight moderation in growth in 2011 to 3.5% from 4.2% in 2010 as fiscal deficit reduction begins in Europe and monetary policy tightens in the emerging markets. Higher oil prices are a threat to growth, but are not expected to cause a return to recession. Emerging market growth is expected to moderate in 2011, but remain relatively robust at 6.0%.

● The near term outlook is slightly stronger than expected last quarter given a run of robust business surveys and the news that there will be extra fiscal stimulus in the US following the decision to extend the Bush tax cuts, unemployment insurance and introduce a payroll tax holiday.

● On the price front, we expect global inflation of 3.5% for 2011, up from 2.5% in our last forecast - a consequence of the increase in food and energy prices. Excluding these factors our inflation view is coming in as expected in the US and Eurozone with the core rate remaining subdued. UK inflation, however, continues to surprise on the upside and looks set to remain above 4% for most of the year.

● OECD inflation is expected to moderate in 2012 as commodity prices stabilise and fiscal and monetary policy begins to tighten.

● For the emerging economies, commodity prices have a more significant impact on inflation, which is expected to remain elevated in 2011. However, as in the OECD, inflation is forecast to moderate in 2012 as policy tightens and commodity prices stabilise.

● Against this backdrop monetary policy is likely to remain loose, but we have brought forward the onset of interest rate increases in the US and Eurozone. In the US, this reflects continued growth and a gradually improving labour market. In the Eurozone the move is also driven by the desire to contain inflation expectations. Inflation concerns prompt the UK to tighten earlier with the first move in August 2011.

● For the US we assume an end to QE in June as scheduled. Policy will shift in September 2011 as the Fed allows passive balance sheet contraction to occur. However, tightening will be slow and we expect the Fed funds target rate to rise to just 2% by the end of 2012.

● We do not believe that the Euro crisis is over and expect concerns over solvency in the peripheral nations to persist through 2011. However, we expect contagion to be contained by enhanced EU support to be announced at the end of March.

● In the emerging economies policy is expected to tighten more rapidly in response to inflationary pressure and concern about asset bubbles. China is forecast to raise interest rates through 2011 and allow a further modest appreciation of the RMB.

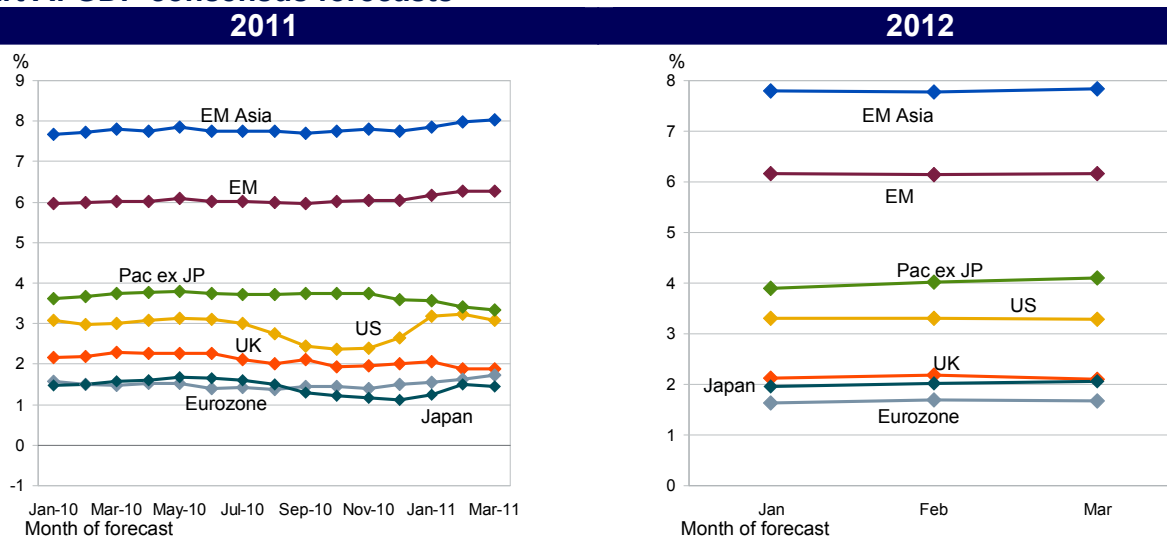
● We continue to expect the USD to strengthen against the EUR reflecting better growth prospects in the US and continuing concerns about sovereign risk in peripheral Europe. The GBP is expected to remain firm in 2011, but appreciates against a weak EUR.

25 March 2011

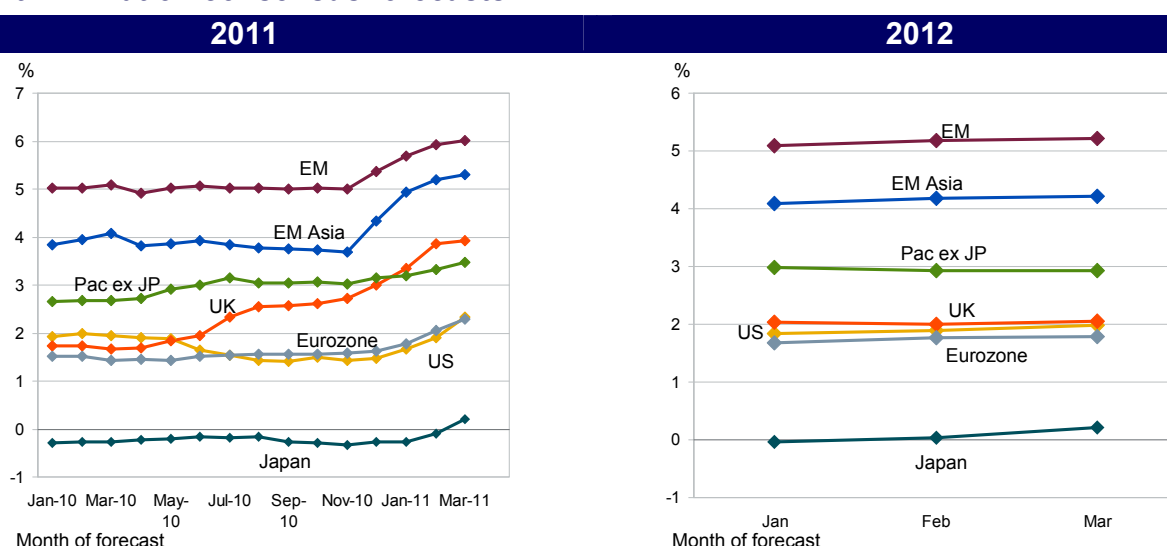
## II. Updated forecast charts - Consensus Economics

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 (March 2011), 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, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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