29 November 2010

For professional investors only

Schroders

Economic and Strategy Viewpoint

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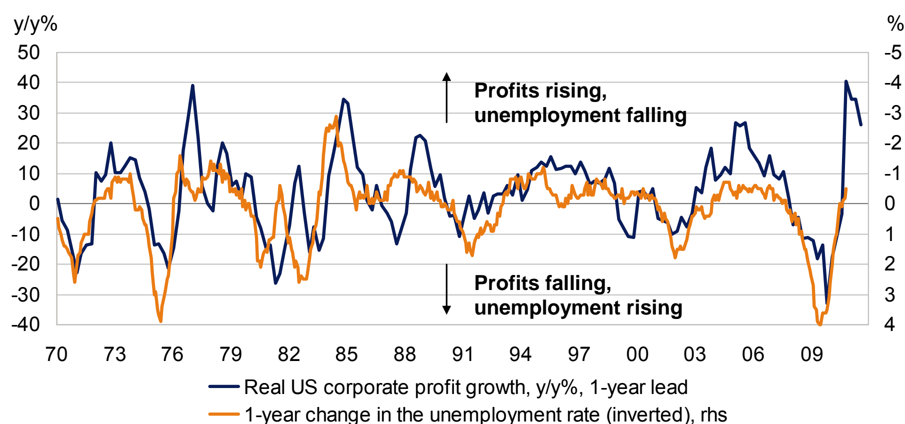
Global Forecast Update

- **Updating our forecasts we continue to believe that the world economy will sustain modest growth through 2011 and 2012, thus avoiding a double dip. Despite the headwind from the ongoing problems in the Eurozone we see a further recovery in the US and expect the emerging markets to continue to perform strongly. Meanwhile, inflation is expected to remain low in the US and Eurozone as the recovery is not strong enough to put upward pressure on prices.**
- **On the policy front, we have pushed out the start of monetary tightening in the advanced economies, such that the first rate rise from the Federal Reserve (Fed) and European Central Bank (ECB) is not expected until March 2012, some six months later than in our previous forecast. We expect the Fed will stick to its schedule for completing $600bn of Quantitative Easing (QE) by next June. Concerns about deflation are then likely to keep the US central bank on hold until they are confident of recovery in early 2012.**
- **The main driver of recovery in the US is expected to be the corporate sector with the upturn in profits feeding through into stronger payrolls and lower unemployment as we move through 2011 (see chart below). This should lift consumer incomes and spending, in effect sharing the gains of the recovery more evenly between firms and households.**
- **The risks to our view are still skewed to the downside with the dangers of an escalation in the Euro crisis and even the break up of the single currency, an outbreak of protectionism, or even a potential war in the Korean peninsula. On the upside though there is the prospect of stronger growth as QE feeds through to liquidity in the emerging world and the chance that US households decide to save less and spend more.**

Eurozone: Mrs. Merkel's mess

- **Just as calm was beginning to settle in peripheral Europe's government bond markets, Mrs. Merkel decided to stoke up fears of sovereign defaults. Germany has successfully persuaded the European Council to include some form of burden sharing in the design of the new bail-out mechanism. The panic has pushed Ireland to follow Greece and seek help, and we expect Portugal to follow very soon.**
- **Looking ahead, we expect growth to moderate in 2011 as fiscal tightening begins in core Europe. Our growth forecast for the region has not changed significantly, but our inflation forecast has been raised slightly, partly because we expect indirect taxes to be raised to help implement tough fiscal cuts. With the European sovereign debt crisis continuing to deepen, we expect central banks to keep interest rates on hold for longer.**

Chart: Surge in profits signal lower US unemployment



Source: Thomson Datastream, Schroders, 26 November 2010

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Global

Forecast update

Modest growth and lower inflation in 2011 – no double dip, but no rate rise from the Fed or ECB

This month we have updated our forecasts and extended the horizon out to 2012. Our central view that the world economy will sustain modest growth and avoid a double dip remains intact, although we recognise that the latest developments in the Eurozone present another headwind to activity.

Relative to consensus for 2011 our views are more optimistic on growth, but we see continued downward pressure on inflation. We also recognise that monetary policy will have to remain loose for longer than previously expected in the US and Europe, such that we do not expect the Federal Reserve or European Central bank (ECB) to tighten policy until March 2012, some six months later than in our last forecast. The UK is expected to raise rates in November next year (previously August) in response to inflation being persistently above target.

Policy to tighten in emerging markets and commodity producing countries

By contrast, policy is still expected to tighten in the emerging world in 2011 through higher interest rates and exchange rates. The commodity producers such as Norway, Australia and Canada are also expected to tighten policy. Such a divergence in policy will be an important theme for currency and bond markets next year.

Euro holds together for now

Our central assumption is that the Euro remains intact over the next two to three years, but that there will be continuing crises with Portugal likely to be the next country to require official support. At this stage we assume that the political will exists within the European Union to continue providing support. However, this would have to be questioned if a large economy like Spain came under pressure.

Political will should hold the Euro project together for now, but will be tested over the medium term

Moreover, on a longer term view we have real doubts as to whether the Euro will still exist in its current form in five years time as the willingness of taxpayers to provide, or debtors to accept, long term support wanes across the region. The lack of competitiveness in the periphery, combined with an absence of fiscal transfers means countries face an extended period of weak growth which will make fiscal consolidation difficult. The subsequent weak economic performance may well ultimately prove politically unacceptable and voters will seek change. Although this would not be an easy option we could see a situation where a group of peripheral countries leave the single currency and the Euro continues with a group of core countries.

We see an earlier break-up in the next two years as a risk rather than the central view. Nonetheless, persistent concerns will put downward pressure on the Euro which is expected to fall against the USD to 1.25 by the end of 2011 and 1.20 by the end of 2012.

What will drive the recovery?

Putting aside the problems of the Eurozone, there are still considerable doubts about the ability of the world economy, particularly the US, to grow in the current environment. Many attribute the recovery to a one off swing in inventory building and do not see where growth in the advanced world can come from, as the public and private sectors de-leverage.

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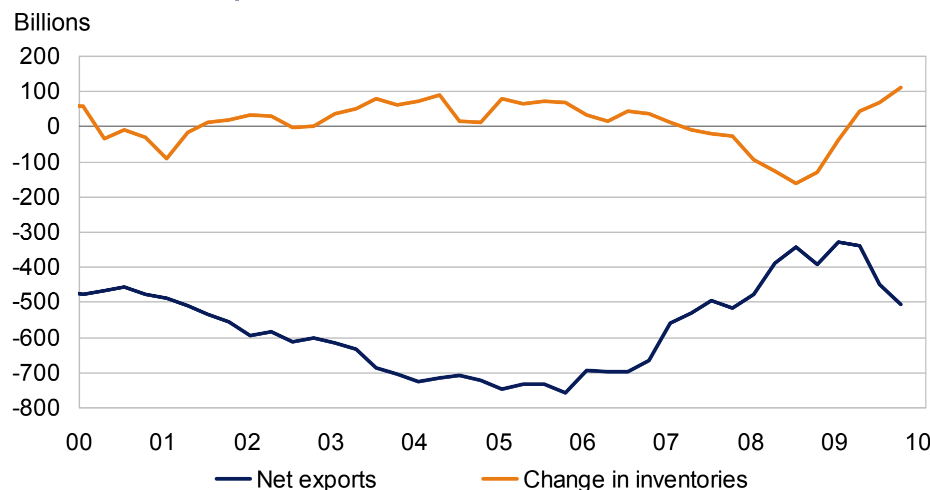
The next phase of the recovery will be less reliant on inventory building and more on final demand

On the inventory cycle we agree that we are close to the peak in terms of the rate of rebuilding. Going forward inventory will continue to build, but will provide less of a boost and growth will depend on final sales, primarily consumption and investment given the constraints on government spending. We have described this as moving from phase 1 to phase 2 of the recovery.

However, the boost from inventory can be overstated as a large proportion is in the form of imports. Consequently, the inventory cycle is inversely correlated with the trade balance and the contribution of net exports to GDP (see chart 1). On this basis, a slowdown in inventory will affect growth, but the effect will be mitigated by a reduction in imports.

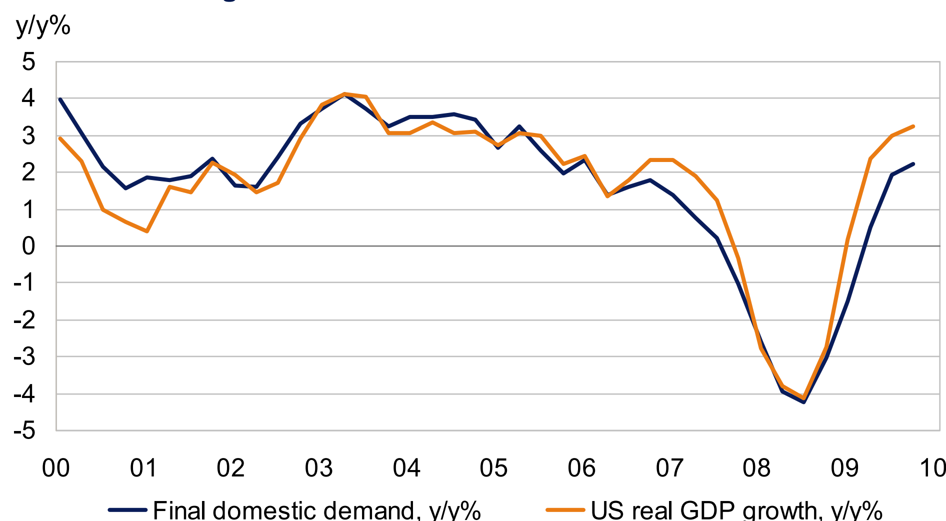
Chart 1: US net exports and inventories



Source: Thomson Datastream, 24 November 2011

To gauge how well the economy is performing without inventory or trade we can look at final sales to domestic purchasers which, although not rising as rapidly as overall GDP, have been gradually gathering pace, rising 2.2% in the year to the third quarter (chart 2).

Chart 2: US GDP growth and final domestic demand



Source: Thomson Datastream, Schroders, 24 November 2011

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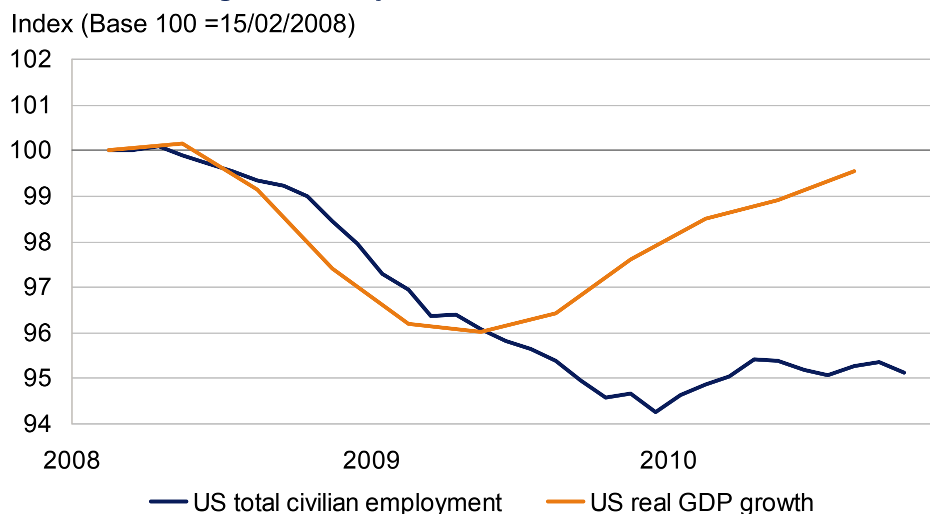
Corporate sector to raise spending in 2011

Our forecast continues to see business fixed investment gathering pace as the corporate sector increases its spending. In 2011, we expect to see firms extend their spending to employment thus boosting job growth in the economy. This will be an important mechanism in sustaining the recovery as higher employment should feed through to higher income and consumer confidence. Admittedly, so far the recovery in jobs has been disappointing such that although GDP has recovered to within 0.5% of its previous peak, employment remains some 5% below (chart 3).

Chart 3: US GDP growth and jobs



Source: Thomson Datastream, Schroders, 24 November 2011

Looking for the corporate sector to spend more on capital and labour in 2011…

Such a development is not unusual in the early stages of a recovery as companies take advantage of the crisis to drive through cost control and efficiency measures. The resulting improvement in productivity has been a key factor behind the rise in profits.

..spreading the gains from recovery more evenly

Looking ahead we would expect the gains of higher GDP to be spread more evenly between labour and capital through a combination of higher wages and employment. Evidence of a firmer labour market can be found in the fall in initial unemployment claims in November and the 150k rise in non-farm payrolls in October. Our forecast assumes that employment improves through 2011 with payroll gains picking up to around 200-250k per month.

Recovery from financial crisis is slow, but much of the downward adjustment has been made

We recognise that any recovery will be sluggish by past standards. The lesson from previous cycles is that recovery from a financial crisis is slow and often choppy. We cannot expect any help from the interest rate sensitive parts of the economy, housing and durables, as households will continue to focus on balance sheet repair. Nonetheless, much if not all of the downward adjustment in these sectors has played out with both at cyclical lows. Similarly, the savings rate has risen sharply and would only need to rise further if households chose to de-leverage more rapidly. Policymakers seem to realise this in the US, UK and perhaps even the Eurozone and will keep interest rates low to facilitate balance sheet adjustment. Consequently, we believe it is too pessimistic to look for a double dip return to recession.

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Risks

Euro crisis, increased protectionism are the downside risks

The risk of a more damaging crisis in the Eurozone continues to hang over us as mentioned above. Looking beyond this, another downside risk would be an outbreak of protectionism as the US grows ever more frustrated with China's currency policy. This remains a significant risk and as we have noted before, protectionist legislation has already been prepared in the US. It would seem though that the chances of such legislation getting through Congress has been reduced by the Republican victory in the mid-term elections, which gave the more free market party control of the House of Representatives.

Going the other way, there is still in our view a danger of growth surprising on the upside. Quantitative easing presents a challenge to any forecaster as it has been largely untried and consequently we do not have a good historical record against which to assess the latest programme. Our central view is that it does not have much impact as Fed bond purchases increase the reserves of the banking sector, rather than boost the real economy.

However, the unknown effect of QE particularly on the emerging world creates the prospect of growth being stronger than expected

However, it has been estimated that much of the Fed's purchases will end up flowing into the emerging markets. This will only add to excess liquidity problems in the region, particularly for China which will have to step up its efforts to sterilise the capital inflow. This is already apparent in asset prices be they Shanghai property, jade, first growth Bordeaux or antique vases found in the UK. The danger is that we see an acceleration in emerging market growth in response to easy liquidity and the fall in the US dollar (a clear effect of QE), creating a genuine inflation problem.

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Eurozone

Eurozone: Mrs. Merkel's mess

Eurozone debt crisis returns…

Just as the dust was beginning to settle in peripheral Europe and Northern Europe was bemoaning the renewed strength of the Euro, Mrs. Merkel upset the relative calm by demanding new conditions to future bail-outs of sovereigns which imply restructuring on privately held debt. The sudden U-turn on restructuring paints a frightening picture of the true level of solidarity within Europe and has since exacerbated the problems in Portugal, and in particular Ireland, with the latter becoming the latest to join the bail-out club.

Making assumptions on the political situation in Europe is incredibly hazardous at the moment. Fortunately, the economic outlook is relatively more certain and we have updated our forecast this month and extended the horizon to 2012.

Looking after number one!

…as Mrs. Merkel demands private sector burden-sharing.

October 29th was the day global investors learnt that Germany was no longer prepared to underwrite all European sovereign debt without some very strict conditions. We had expected these conditions to include tough implementation of the Maastricht criteria on deficits and debt, but what came as a shock was the proposal to introduce some form of private burden sharing – code for potential restructuring and haircuts on sovereign debt held by private investors.

The new system effectively removes government guarantees on capital being returned to investors and as a result, means that additional risk premiums will be added to yields. With the current backstop facility, a country must show that a market is closed to it, but importantly, no debt is restructured, and governments must implement strict fiscal tightening. The new system means that if yields reach a certain level, the maturity on the bonds may be automatically increased, or haircuts may be implemented.

The instant market reaction to the news was a sharp rise in credit default swaps and government bond yields for European peripherals as investors began to price in potential restructuring.

The new permanent crises resolution mechanism will come into force from mid-2013…

Escalating fears and the sell off in risk assets threatened to overshadow the debate at the G20 over the appropriateness of US monetary policy and China's currency regime. As the G20 meeting was reaching its climax, European leaders scrambled a statement to re-assure markets that any proposals for burden-sharing would accompany the new permanent crisis resolution mechanism, which will not come into force until after the current European Financial Stability Fund (EFSF) expires in mid-2013, and would only apply to new bonds issued under the scheme.

Since the G20 meeting, more details were announced. The new scheme will be called the European Stability Mechanism (ESM) and will include Collective Action Clauses (CAC) which will force all bond-holders to take a hit when Europe decides that debt is becoming punitive. The ESM will have a special status and will only be junior to IMF loans. How the CAC will apply is anybody's guess. France has managed to remove the automatic clauses that Germany pushed for, and so each individual default/restructuring will be looked at on a case by case basis.

…however, until its limits are tested, we expect more market volatility.

In our view, the lack of clarity on the how exactly the ESM will work will mean that bond vigilantes have found a new target. Until the limits of the ESM are tested, we expect uncertainty and volatility in European debt markets to continue.

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Meanwhile, the peripherals have not been saints either…

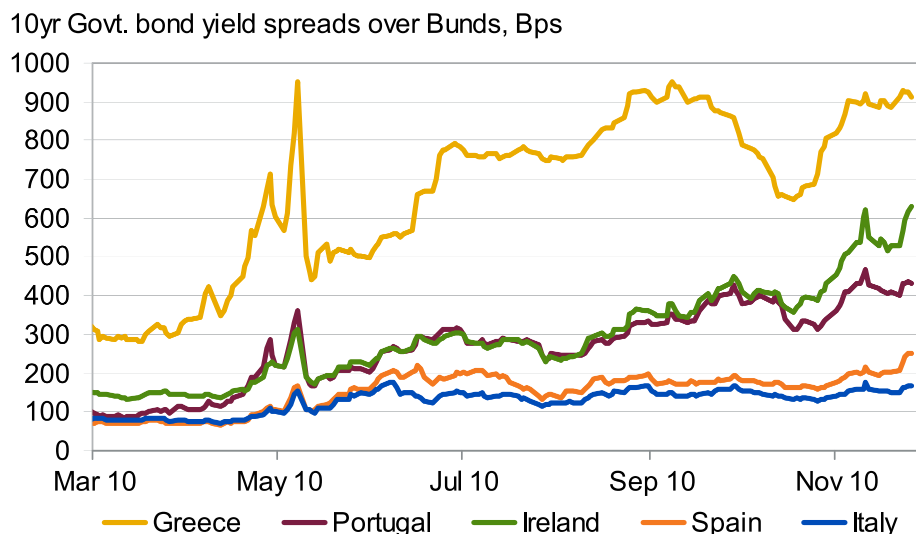
Meanwhile, peripheral governments were up to their old shenanigans, not helping their own situations. Portugal twice delayed the vote on their 2011 budget after the minority government struggled to stop opposition parties voting down their plans. Meanwhile, the Greek Prime Minister George Papandreou threatened to call a general election should his party have failed to win enough seats at the local elections which took place earlier this month. Finally, Ireland downgraded their growth forecast which implied the need for even more help for their troubled banks, but also additional fiscal tightening. Ireland is now expected to post a 32% of GDP deficit, after providing approximately 20% of GDP to the banking system.

The scales have fallen in Irish eyes

…Ireland looked increasingly in trouble as it put more money into its troubled banking sector.

Ireland held out for as long as it could before Prime Minister Brian Cowen finally threw in the towel and put out the begging bowl. Though the Irish government is funded until approximately the middle of next year, it was becoming increasingly clear that Irish banks could not raise funding independently and were becoming totally reliant on the ECB and the Irish government. The collateral that Irish banks have been using to access ECB loans was dwindling and so fears of the need for more recapitalisation from the Irish government quickly caused the Irish sovereign debt market to seize up (see chart 4).

Chart 4: 10yr Government bond yield spreads over Bunds



Source: Datastream. Updated 29 November 2010.

Ireland eventually followed Greece and asked for its own loan package.

The uncertainty over Ireland was blamed for the spread of contagion and immense pressure was placed by the European Union (specifically Germany) to officially ask for a bail-out. Though discussions of the issue were always denied, speculation was rife that Ireland was holding out for a deal that meant that it could protect its cherished 12.5% corporate tax rate (which is very low compared to the rest of Europe). After making the formal request, Ireland announced a four-year austerity plan designed to satisfy European partners.

The Irish 'National Recovery Plan', Ireland's 5th instalment in its ongoing austerity saga, aims to trim €15bn from its budget, with headline measures including a rise in VAT by 2% to 24% by 2014, €1.9bn raised through lowering the threshold for income tax, and cutting €2.8bn from the welfare budget.

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The government aims to cut the deficit quickly, but without harming Ireland's competitiveness. In addition to freezing its corporation tax, Ireland will lower its minimum wage by 12%. Though we do not expect this to cause falls in wages in the short-term, it should boost employment by lowering the marginal cost of hiring.

Bail-out no. 2, but some lessons learned

€85bn package was announced to aid Ireland…

In typical fashion, the Irish Government along with the European Commission, IMF, ECB and European Finance Ministers, thrashed out a €85bn bail-out on Sunday 28th November. €17.5bn of the bail-out will come from Irish cash reserves and the national pension fund, while the rest from external sources. €22.5bn is coming from the EU wide European Financial Stability Mechanism (EFSM), another €22.5bn from the European Financial Stability Fund (EFSF) which includes bi-lateral loans from the UK (€3.8bn), Sweden (€0.6bn) and Denmark (€0.4bn), and a final €22.5bn from the IMF, funded through the external fund facility.

Of the €85bn package, €10bn is being injected directly into the banking system, while another €25bn is being reserved for future banking losses. Importantly, senior bond holders will not face hair-cuts, a key sticking point for the ECB's support, which feared that haircuts could cause a second credit crunch.

The package will cost on average 5.8% per year for Ireland, slightly higher than the 5.2% rate for Greece, but it seems that the Europe has learnt from the errors of the Greek bail-out.

Firstly, Ireland has been given an extra year (to 2015) to bring its deficit back down under the Maastricht Treaty's 3% of GDP limit. This means less aggressive fiscal consolidation, which should help reduce the negative impact on GDP growth.

…which will last for 7.5 years, a big improvement on the Greek style 3-year deal.

Secondly, the average maturity of the loan package is 7.5 years, considerably longer than the 3 year package Greece received. This gives Ireland a much more realistic chance of not only eliminating most of their government deficit, but also stabilising the economy and returning to more normal levels of growth. Incidentally, the Greek loan package is also set to be increased to match a similar maturity for Ireland, though details remain scarce at this time.

Nice try, but no cigar

Despite the announcement of the Irish bail-out package and the Irish National Recovery Plan, the yield on Irish government bonds continues to rise, and the Euro continues to fall against most other currencies. While we think the package is a good deal for Ireland, there are three key areas of concern.

However, we are concerned that Ireland will not be fully funded with the package…

The first is the size of the package. Of the €85bn deal, only €50bn has been set aside to aid the sovereign meet its financial obligations. However, Ireland needs to refinance €49bn worth of existing debt between 2011 and 2014, and if it sticks to its latest budget plans, Ireland will need to borrow an additional €14bn to finance its existing primary deficit (chart 5 on next page). This means that unlike Greece, Ireland will not be fully funded and so will have to keep going back to the market to make up the short-fall. On the one hand, it means that the sovereign will continue to be visible in the market. On the other hand, it means that it continues to be exposed to the high yields that the market is demanding for Irish debt.

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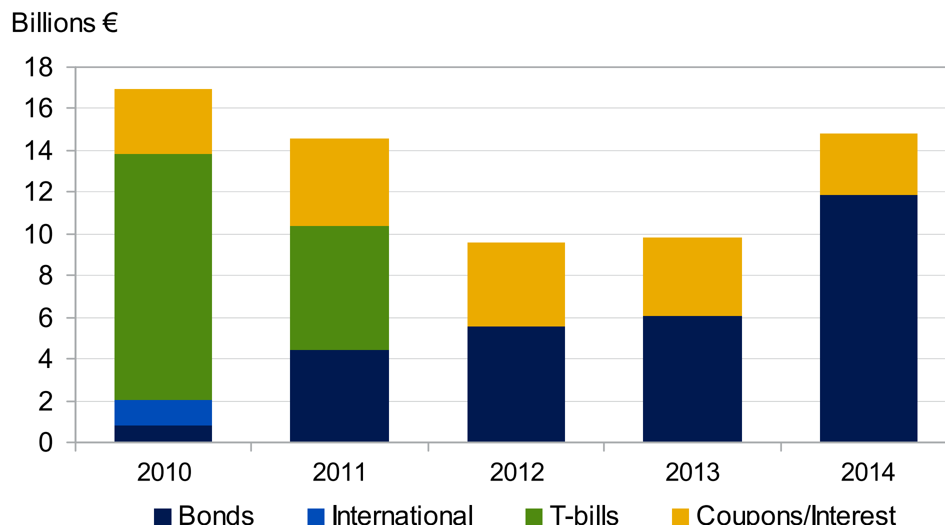
Chart 5: Irish government refinancing schedule

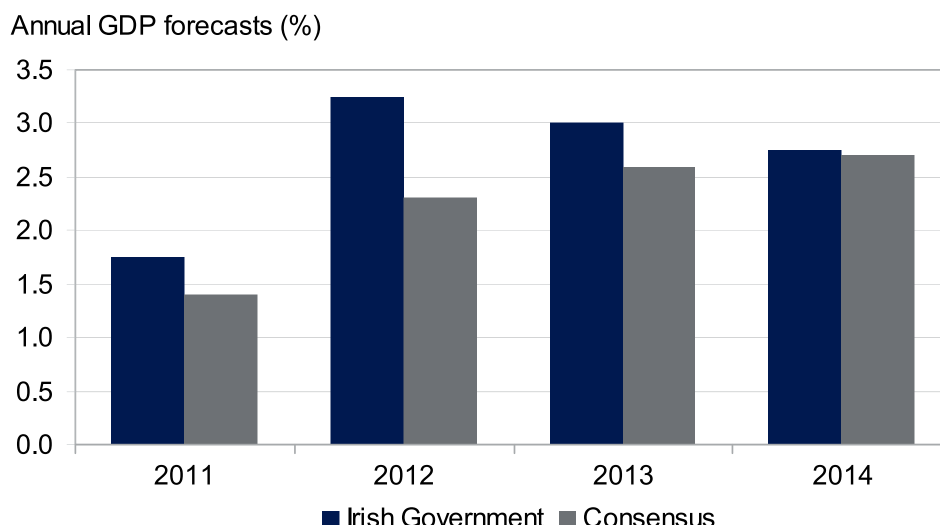


Source: Bloomberg, Schroders. Updated 29 November 2010.

…and the Irish government has a relatively optimistic growth forecast…

The second area of concern is the government's assumed growth trajectory, which even before the latest fiscal austerity package is optimistic relative to consensus forecasts (chart 6). If growth disappoints against the governments forecast, then tax revenues will fall short of targets, and the government may have to raise taxes or cut spending even further.

Chart 6: Comparison of GDP forecasts for Ireland



Source: Republic of Ireland Ministry of Finance, Consensus Economics. Updated 29 November 2010.

…and with an election due in January, a new government may derail the whole deal.

The third area of concern is the political uncertainty that has emerged in recent weeks. Cowen caved in to pressure from the junior coalition Green Party to hold a general election after the budget has been passed. An election is now due at the end of January 2011 but the opposition has already suggested that it intends to change the budget plans if it wins power.

Should power change hands in 2011, there is a risk that the new government could change the nation's fiscal plans to the point that support from Europe and the IMF is withdrawn.

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When it rains, it pours

There are also concerns that the EFSF may not be big enough, especially if Spain needs help.

To top-off all the political uncertainty, fears are now emerging that the current EFSF may not be large enough to bail-out Spain should contagion eventually spread that far. As more and more countries ask for bail-outs, the size of the fund diminishes. Table 1 below shows the initially agreed liability split amongst Eurozone countries, but Table 2 shows the likely funding should the worst happen. Note that the new Slovakian government has already declared that it will not be underwriting its previously agreed proportion of the fund.

Table 1: Initial proposed funding	
Germany	119,390.07
France	89,657.45
Italy	78,784.72
Spain	52,352.51
Netherlands	25,143.58
Belgium	15,292.18
Greece	12,387.70
Austria	12,241.43
Portugal	11,035.38
Finland	7,905.20
Ireland	7,002.40
Slovakia	4,371.54
Slovenia	2,072.92
Luxembourg	1,101.39
Cyprus	863.09
Malta	398.44
Total	**440,000.00**

Table 2: Likely Crisis funding	
Germany	119,390.07
France	89,657.45
Italy	78,784.72
~~*Spain*~~	~~*52,352.51*~~
Netherlands	25,143.58
Belgium	15,292.18
~~*Greece*~~	~~*12,387.70*~~
Austria	12,241.43
~~*Portugal*~~	~~*11,035.38*~~
Finland	7,905.20
~~*Ireland*~~	~~*7,002.40*~~
~~*Slovakia*~~	~~*4,371.54*~~
Slovenia	2,072.92
Luxembourg	1,101.39
Cyprus	863.09
Malta	398.44
Total	**352,850.47**

Source: European Union

The dwindling size of the EFSF may only be a short-term concern if Spain survives post 2013, but even the new and permanent ESM could run into similar difficulties. The size of the ESM has not been announced yet and so we can rest assure that this will be another negotiating point that will unsettle markets.

European forecast update

Compared to the political mess in Europe, the economic outlook is more positive than this time last year. Growth has surprised on the upside with a blockbuster performances from Germany, Austria and Finland.

European growth set to slow in 2011 as fiscal consolidation gets underway.

For 2011, we expect the start of fiscal tightening in Germany and in France to moderate growth in the Eurozone. As the larger, stronger of the Eurozone economies who also hold AAA sovereign debt ratings, Germany and France have been able to use fiscal policy to continue to stimulate their economies, without fear of market reprisals. However, in order to lead by example, both are expected to begin cutting their deficits in 2011, so that they too can meet the Maastricht Treaty's 3% of GDP limit by 2013.

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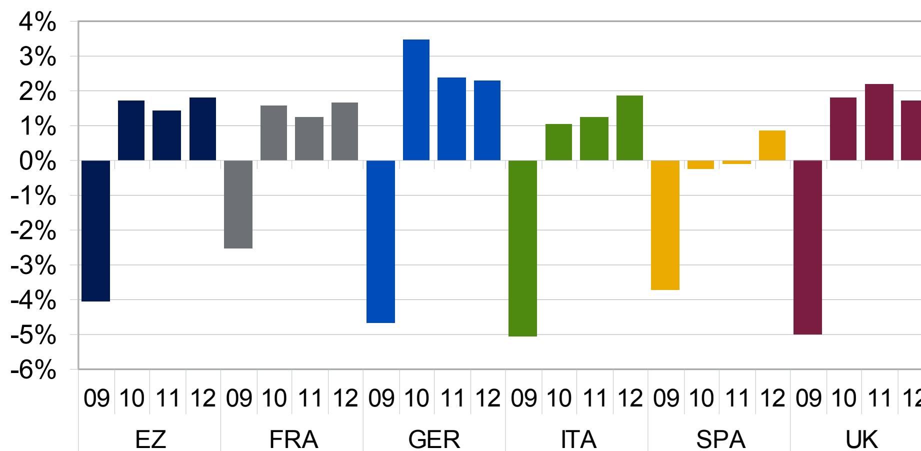
As a result of the reversal of fiscal stimulus, we forecast annual real GDP growth for the Eurozone to fall from 1.7% in 2010 to 1.4% in 2011, before re-accelerating to 1.8% in 2012 as final demand begins to recover on the back of rising employment growth (see chart 7).

Chart 7: Growth forecast to ease



Source: Eurostat, Schroders forecast. Updated 26 November 2010.

Growth within Europe is likely to diverge…

Though aggregate Eurozone growth has been reasonably robust of late, the headline numbers hide a stark divergence between the export-orientated core economies and peripheral Europe. For example, at the end of the third quarter of this year, Germany was growing by 3.9% compared to a year earlier, while Greece has been contracting by 4.3% over the same period.

The impact from aggressive fiscal tightening in the peripherals can be seen when examining the recent collapse in household sentiments. Chart 8 shows how consumer confidence initially began to recover in 2009 following the credit crunch, but then rolled over and precipitated as fiscal tightening accelerated this year. In contrast, consumer confidence in northern Europe has recovered strongly, and for Germany, Sweden and Austria, confidence is now one standard deviation above its long-run average (chart 9).

…with weaker growth in the peripherals, and stronger growth in the export-oriented economies.

Chart 8: Peripheral consumer confidence

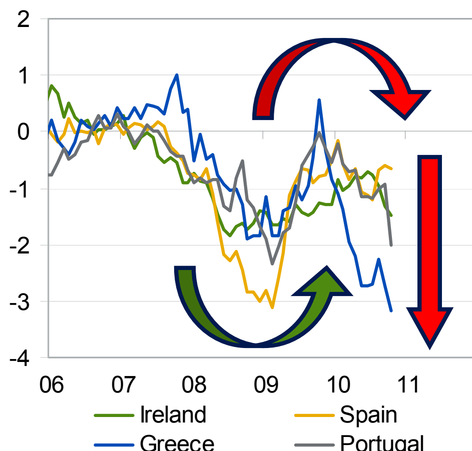
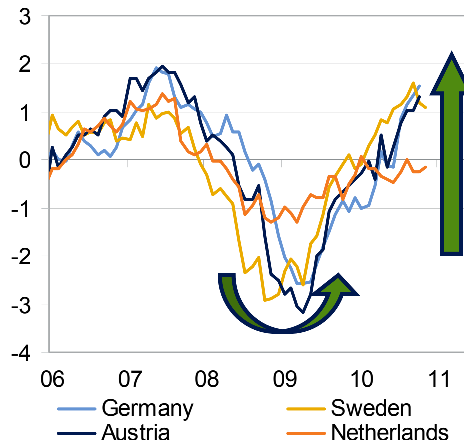


Chart 9: Core consumer confidence



Source: Datastream, European Commission. Updated: 25 November 2010.

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The continued strength in northern Europe has not been limited to households. The latest purchasing managers indices (PMIs) show not only strong growth in the composite headline indicators but also within the sub-indicators, such as output, new orders, and even employment (see charts 10 and 11 for German and French PMIs).

Chart 10: German composite PMIs

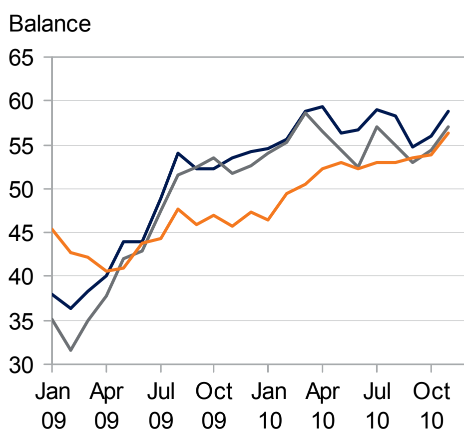
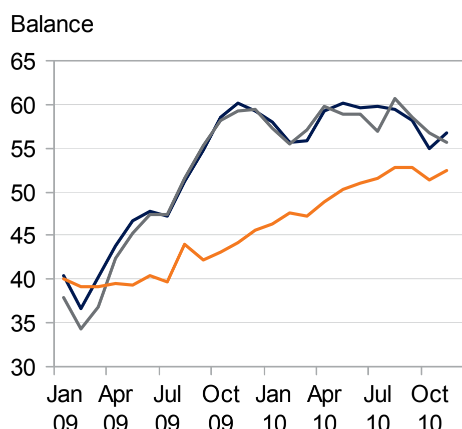


Chart 11: French composite PMIs



Source: Markit. Updated: 29 November 2010.

The broad based strength in the PMIs is important. Now that the boost from the inventory cycle is fading, final demand must recover if the momentum in growth can be maintained (see global section for a fuller discussion). The continued growth in new orders as indicated by the PMIs suggests that final demand is coming through, and should support output in the coming months.

Even more encouraging has been the way that the pick up in demand and output is feeding through to an increase in employment, which is helping to start the virtuous upward cycle in domestic demand.

The strength in activity reported by the private business surveys make us more confident that core Europe will only experience a moderation in growth as fiscal tightening begins.

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Forecast Summary
I. Forecast summary

Real GDP

y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus	2012	Consensus
US	26.4	**-2.6**	**2.8**	2.7	**2.7**	2.4	**2.6**	3.3
UK	4.1	**-5.0**	**1.8**	1.7	**2.2**	2.0	**1.7**	1.8
Eurozone	23.5	**-3.6**	**1.7**	1.6	**1.5**	1.4	**1.8**	1.6
Japan	9.5	**-5.3**	**2.7**	3.0	**1.2**	1.2	**1.5**	2.0
Australia	1.9	**3.5**	**3.0**	3.3	**3.2**	3.5	**3.0**	3.4
OECD	65.4	**-3.3**	**2.3**	**2.3**	**2.1**	**1.9**	**2.1**	**2.4**
China	9.1	**9.1**	**10.0**	10.1	**9.0**	9.1	**8.5**	8.9
Emerging*	34.6	**1.1**	**6.5**	7.1	**6.0**	6.0	**6.0**	6.2
World	100.0	**-1.8**	**3.8**	**3.9**	**3.4**	**3.3**	**3.5**	**3.7**

Inflation CPI

y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus	2012	Consensus
US	26.4	**-0.4**	**1.6**	1.6	**0.9**	1.4	**0.8**	2.0
UK	4.1	**2.2**	**3.2**	3.2	**3.3**	2.7	**2.6**	2.1
Eurozone	23.5	**0.3**	**1.7**	1.5	**1.6**	1.6	**0.9**	1.5
Japan	9.5	**-1.4**	**-1.0**	-0.9	**-0.3**	-0.3	**-0.2**	0.3
Australia	1.9	**1.8**	**2.6**	2.9	**3.0**	3.0	**3.0**	2.8
OECD	65.4	**0.0**	**1.4**	**1.3**	**1.2**	**1.4**	**0.9**	**1.6**
China	9.1	**-0.7**	**3.3**	3.0	**3.2**	3.0	**3.0**	3.3
Emerging*	34.6	**4.3**	**5.2**	5.1	**5.0**	4.8	**4.5**	5.0
World	100.0	**1.5**	**2.7**	**2.6**	**2.5**	**2.6**	**2.1**	**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-09	Dec-10	Market	Dec-11	Market	Dec-12	Market
US	26.4	0.25	0.25	0.31	0.25	0.70	1.25	1.26
UK	4.1	0.50	0.50	0.76	0.75	1.19	2.00	1.96
Eurozone	23.5	1.00	1.00	1.06	1.00	1.47	1.75	1.92
Japan	9.5	0.10	0.10	0.35	0.10	0.39	0.25	0.42
OECD	63.5	**0.52**	**0.52**	0.62	**0.54**	0.97	1.33	1.42
Market data as at				23/11/2010				

Key variables

FX	*Current*	Dec-09	Dec-10	y/y%	Dec-11	y/y%	Dec-12	y/y%
USD/ GBP	*1.58*	1.62	1.60	-1.4	1.60	0.0	1.60	0.0
USD/ EUR	*1.34*	1.46	1.34	-8.1	1.25	-6.7	1.20	-4.0
JPY/ USD	*83.2*	90.0	83.0	-7.8	85.0	2.4	90.0	5.9
GBP/ EUR	0.85	0.90	0.84	-6.8	0.78	-6.7	0.75	-4.0
Brent crude	*82.6*	74.9	84.0	12.2	84.5	0.6	87.1	3.1
US output gap %GDP	*-7.3*	-8.0	-6.5		-4.9		-3.6	
Unemploy. %	*9.6*	10.0	9.5		8.8		8.3	

Source: Schroders, Datastream, IMF, Consensus Economics

Steady Growth, Low Inflation

● We continue to forecast a weak recovery for the world economy with a moderation in growth in 2011 to 3.4% from 3.8% this year as fiscal deficit reduction begins and the de-leveraging process continues to temper consumer spending. We are not forecasting a double dip, but do expect a period of sub-trend growth in the OECD economies over the next two years.

● Emerging market growth is expected to moderate in 2011, but remains relatively robust at 6%. The near term outlook is slightly stronger than previously expected given the weaker USD and strength of liquidity in the region.

● 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 EU/ IMF support and for the Euro to remain intact over the forecast period.

● On the price front, we expect global inflation of 2.5% for 2011. Our low inflation view is coming in as expected in the US and Eurozone. UK inflation, however, continues to surprise on the upside and looks set to remain above 3% through next year.

● For the emerging economies, inflation is expected to remain elevated in 2011, although is forecast to moderate later in the year as policy tightens and commodity prices stabilise.

● Relative to consensus for 2011 we are marginally more optimistic on growth, but expect lower inflation. It is too early to put much weight on 2012 consensus.

● On the policy front, 2011 should mark the first year of fiscal tightening since the financial crisis with a reduction in the G-20 cyclically adjusted deficit of about 1% of GDP. This compares with a loosening of policy of about 0.5% GDP in 2010 (based on IMF figures).

● Against this backdrop monetary policy is likely to remain loose and we have delayed the onset of interest rate increases in the US and Euro-zone until March 2012. UK tightening also pushed out but only to November on Inflation concerns.

● For the US we assume an end to QE in June next year as scheduled. Policy will shift in November 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 1.25% by the end of 2012.

● 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 further modest appreciation of the RMB.

● We continue to expect the USD to strengthen against the EUR as concerns about sovereign risk remain high in peripheral Europe. The GBP is expected to remain firm in 2011, but appreciates against a weak EUR.

26th November 2010

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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

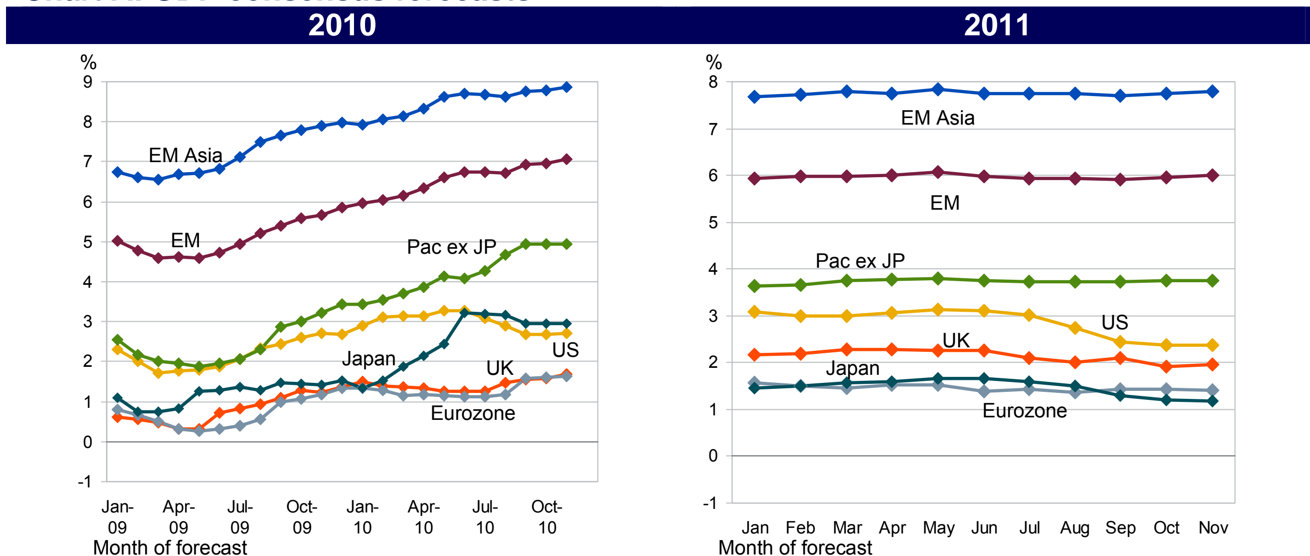
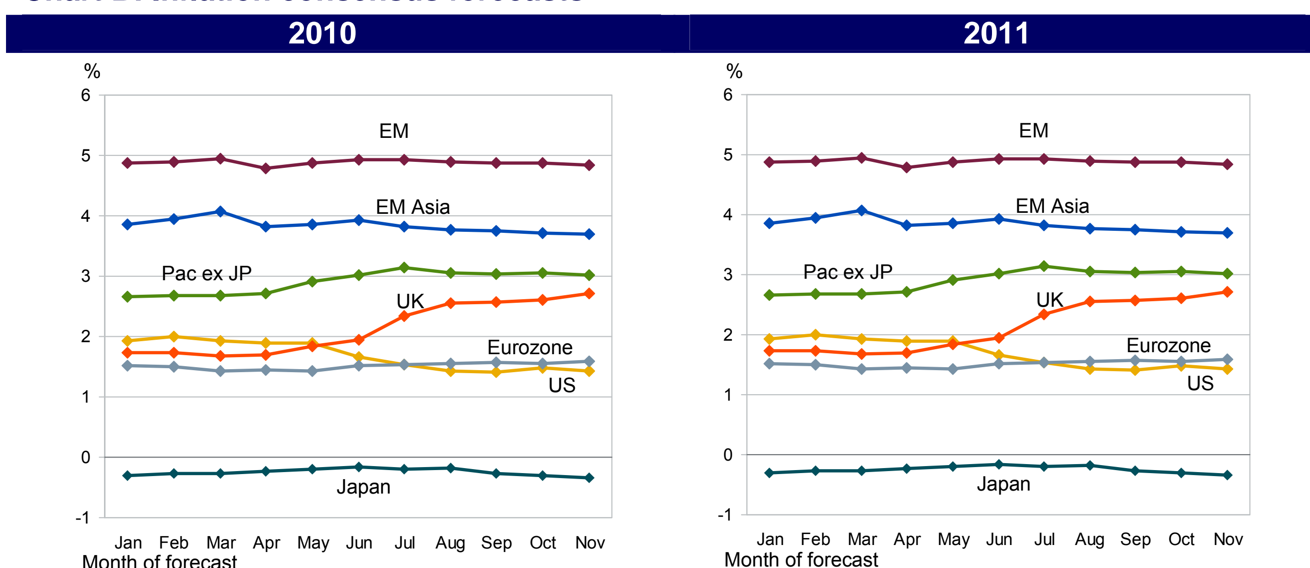


Chart B: Inflation consensus forecasts



Source: Consensus Economics (November 2010), 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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