28 July 2011

For professional investors only

Schroders

Economic and Strategy Viewpoint

Keith Wade
Chief Economist and Strategist

Azad Zangana
European Economist

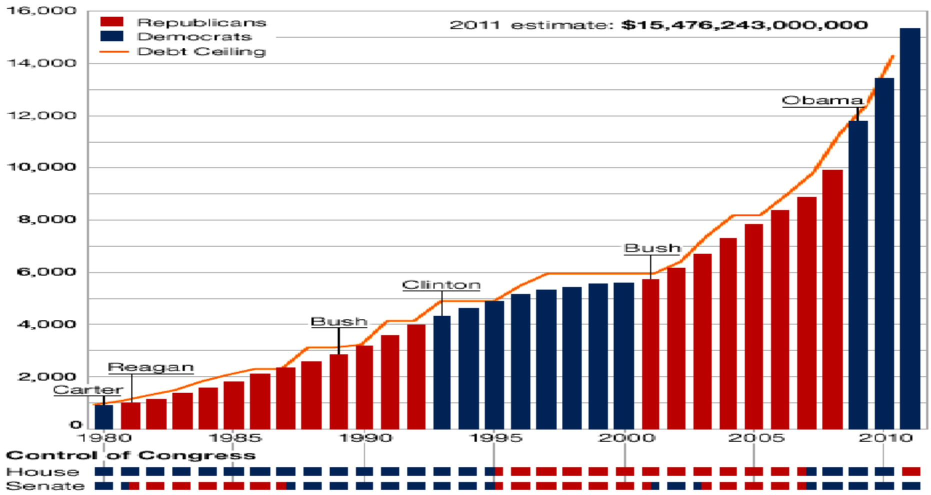
Global: debt woes bring political risk to the fore

- **Markets have focussed on the debt problems of the US and Europe over the past month with the progress of the recovery taking a backseat. Gold has moved higher and the US dollar has weakened however, despite the deadlock in the debt negotiations and the risk of a default, US Treasuries have been firm.**
- **One explanation would be the widely held view that a last minute deal will be agreed by the Republicans and Democrats, or as some argue, the US Treasury will find a way of meeting coupon payments even in the event of a failure to lift the ceiling.**
- **This may prove optimistic, what can be said with some certainty though is that an agreement to lift the debt ceiling will not be the end of the story. S&P have made it clear that the US could still be downgraded unless a long term solution to the deficit is found. Given the polarisation that exists between the political parties such a solution between a re-elected President Obama and a divided Congress seems unlikely. Investors can look forward to more political wrangling and a likely downgrade to US government debt.**

UK: Bad luck or a more serious problem?

- **The UK economy slowed to almost a stand still in the second quarter sparking a chorus of doubters calling for a 'Plan B' from the government, and even more quantitative easing from the Bank of England. Is this the start of a downward spiral, or is there a good reason behind the disappointing growth numbers.**
- **Special temporary factors have had a major impact on the latest set of data. The biggest has been the extra bank holiday in April to celebrate the royal wedding. Excluding the impact of the special factors, growth would have accelerated rather than slowed.**
- **We believe that underlying growth in the economy remains robust and that we should see a pick up in the second half of the year. Despite pressure, the government is unlikely to deviate from its current fiscal strategy, while the Bank of England should resist temptations to restart quantitative easing.**

Chart: US debt ceiling, $Bn



Source: Whitehouse.gov, BBC

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Global

Debt woes bring political risk to the fore

Recovery takes backseat as markets focus on moves to solve debt problems

The progress of the economic recovery has taken a backseat over the past month as markets have focussed on the fiscal struggles in the US and Eurozone. Lack of progress on lifting the debt ceiling in the US means there is still a risk of a default by the US government on Treasury bonds. The deadline for an agreement is August 2nd, shortly after this report is released, although it may still be possible to gain a further extension. Meanwhile, as the US runs the risk of creating a "voluntary" sovereign debt crisis, European leaders have been working to avoid an inevitable default with a second bailout package for Greece.

Not surprisingly this backdrop has been good for gold which has now broken through the $1600/ oz level. Fearful of default, investors are seeking alternative risk free assets to AAA rated government debt and the "barbarous relic" has been a beneficiary. Gold and other commodities have also benefitted from weakness in the US dollar. Yet, despite the deadlock over the debt ceiling, US Treasury bonds have remained firm with 10 year yields hugging 3% (see chart 1). Given that the past month has also seen the end of quantitative easing, the Treasury market has been remarkably resilient in the face of political risk.

Gold moves higher, but Treasuries remain firm

Chart 1: Gold pushes higher whilst Treasury yields stay firm

Source: Datastream, updated 26 July 2011.

US – heading for a voluntary default?

One explanation for the lack of reaction in US Treasuries would be that investors simply do not believe that politicians will fail to lift the debt ceiling. Whilst this may show touching faith in the ability of a divided Congress to do the right thing, this is looking like more of a risk as the deadline approaches and the gulf between Republicans and Democrats remains.

Consensus is that coupons will be paid

One hope is that in the event of failing to lift the ceiling, coupon payments will be prioritised and there have been discussions between the Whitehouse and Treasury on how this might be achieved. Gold sales from reserves have been mentioned as a source of funding, for example. How politicians then justify prioritising investors whilst cutting public services remains to be seen. The consensus is that coupons will be paid, even though this would mean potentially missing a large social security payment on August 3rd.

Ratings agencies signal downgrades

The ratings agencies, however, have been clear: S&P, Moody's and Fitch say they would downgrade the US in the event of failing to lift the debt ceiling and a coupon or principal payment is then missed. S&P have also said they would put the US in selective default in these circumstances. Should this occur and be followed by other agencies there could be an almighty scramble for the remaining AAA rated securities with some investors having little option but to sell Treasury bonds.

Creating a potential shortage of AAA securities

Although Treasuries are only one third of the Barclays US aggregate index, three quarters of the credit profile is AAA due to the implicit backing of agency and agency MBS by the US Treasury. On the basis that this would also be downgraded, only 5% of debt in the Barclays aggregate would be AAA, according to Ned Davis Research.

The hope would be that any default is only temporary and the ratings agencies have said they would move the US back to a AA range if the debt ceiling was increased and missed payments made whole. Nonetheless, this still represents a downgrade from current levels.

At present the offer from the Republicans is to lift the ceiling in two steps with the result that another decision would be needed in six months time. Not surprisingly, the Obama administration are keen to avoid this as it would mean that the issue would return during the Presidential election year.

Long term solution is needed

Looking further ahead though, whatever the outcome in the near term, a solution to the deficit needs to be found. Figures from the OECD show the US is expected to run a deficit of 10% GDP in 2011 with total public debt rising above 100% GDP. The lack of political consensus means that the deficit is only expected to fall to 9% of GDP in 2012, with outstanding debt rising to 107% GDP. S&P have indicated that even if the debt ceiling is lifted and no coupons or principal payments are missed they could still downgrade the US if long term measures are not put in place to bring down the deficit.

Gap between the parties is wider than at any time since the civil war

This suggests that the current debate on the debt ceiling will be just a taste of things to come. It is not that Republicans and Democrats cannot come together, but that the likelihood of agreement is low when views are so polarised. For example, although difficult to quantify, academic estimates suggest that the ideological gap between the two parties on the issue of the role of government in the economy is currently wider than at any time since the civil war[1]. If President Obama is re-elected, but the House remains under Republican control we can look forward to four years of political wrangling over the deficit.

[1] See Polarised America by McCarty, Poole and Rosenthal. http://polarizedamerica.com/#POLITICALPOLARIZATION

US debt likely to be downgraded, but reserve currency status may still prevent a funding crisis…

Will we see a crisis as a result with bond yields spiking higher? There seems to be a high probability of US government debt being downgraded. This might trigger a funding problem and some switching by investors, but the US still has the advantage of being the reserve currency of the world. Unless central banks in Asia and the Middle East stop hoovering up dollars then yields could remain range bound.

…which would be a pity

This is unfortunate in that a financial crisis, whilst painful, would probably be the one thing which would unite politicians in taking action as they try to stabilise markets and counter the adverse impact on growth. The bond market vigilantes who kept politicians in check in the past have gone and with them so has the conventional wisdom that political gridlock is good for markets.

Greek bailout 2.0

Latest package kicks Greece into touch, but leaves unanswered questions

On Europe, the latest package is seen as a step forward in that it reduces the levels of Greek debt outstanding through (a) imposing a haircut on bond holders who now face the choice of "voluntarily" rolling over their holdings, and (b) giving a greater role to the European Financial Stability Fund (EFSF), creating a framework for dealing with future crisis.

Our European economist Azad Zangana has given our reaction to the package[2] which makes us marginally more optimistic as it should kick Greece into touch for a period. In our view though it leaves two unanswered questions.

The first is whether Portugal and Ireland will come forward and ask for a similar package. Although EU leaders have said that Greece is a one off, it may be difficult not to treat the other two bail-out countries in the same way. Secondly, there is still a danger of contagion to Spain and Italy which would require a much larger bail out fund.

The one factor which would help both the US and Europe is, of course, growth. Unfortunately at this point the post financial crisis economy in the US and Europe seems unlikely to be able to deliver the above trend increases in activity needed to significantly bring down unemployment and the budget deficit.

[2] See 22 July 2011 Schroders Quickview: Merkel and Sarkozy throw the kitchen sink at the peripheral debt problem. http://www.schroderstalkingpoint.com/node/1117

UK

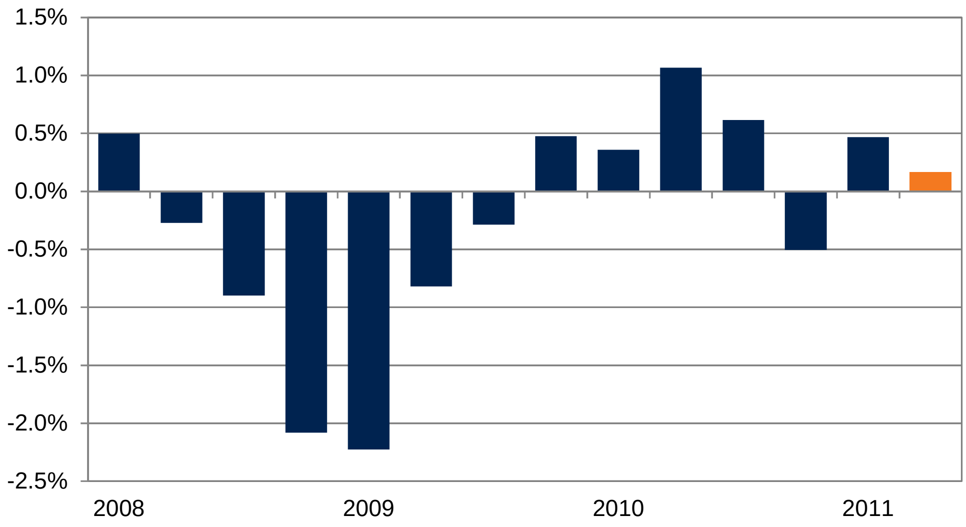
Bad luck or a more serious problem?

GDP Growth disappoints, again, rising by just 0.2% in Q2

Yet another dissapointing GDP print in the UK, once again sparking a debate about the state of the UK economy, and whether a 'plan B' is needed.

The Office for National Statistics estimates real GDP growth to have slowed from 0.5% in the first quarter of the year, to just 0.2% in the second quarter of the year (see chart A). This means that the economy has grown by just 1.4% over the first half of the year on an annualised basis – close to half of the previously estimated trend rate of growth. At this rate, it could take another two and a half years before output returns to its pre-recession peak back in Q1 2008.

Chart 2: Quarterly real GDP growth



Source: Office for National Statistics. Updated 27 July 2011.

The poor growth data has raised questions over whether a 'plan B' is needed

In commenting on the data, Chancellor George Osborne said: *"The positive news is that the British economy is continuing to grow and is creating jobs. And it is positive news too that at a time of real international instability we are a safe haven in the storm."*[3]

Shadow Chancellor Ed Balls took a predictably different view, accusing the Chancellor of being "*breathtakingly complacent",* blaming the government's tax and spending policy. The opposition Labour party is calling for a new strategy on growth, in particular, a reversal of the VAT hike earlier this year, and slower and smaller cuts to public sector expenditure.

Though we are unbiased in analysing the political situation in the UK, we would point out that there was little difference between the previous Labour Party Chancellor's budget plans, and the current plans being implemented by the coalition government. Regular readers will remember that we had predicted VAT to rise before the 2010 general election, regardless of which party would be victorious.[4]

[3] Widely reported in press on 27 July 2011.
[4] See *"Revising UK inflation forecast on expected VAT hike"*, 26 April 2010.

More special factors

The UK was hit by three special factors….

This is the second GDP release in the past year that has dissapointed. The half a percentage point contraction in the final quarter of last year was blamed on heavy snow disrupting business. This time, there were three special factors mentioned in the ONS' release that contributed towards the slowdown in activity:

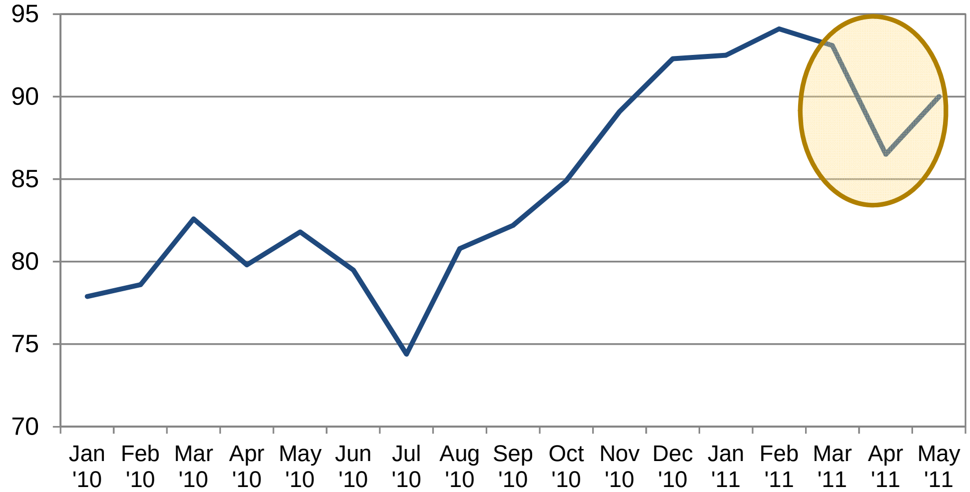
The first special factor is the impact of the tragic earthquake and tsunami in Japan. Although only 2.5% of UK exports go to Japan, 3.5% of UK imports are from Japan, with a significant proportion going to the car manufacturing industry.[5] The closure of Japanese manufacturing plants meant that UK car manufacturers that are reliant on these plants had to slow production significantly. For example, the Honda plant in Swindon, Wilshire said that it would halve weekly production from April, while Toyota announced it would close its Burnaston factory in Derbyshire for two days each week in May.[6]

The earthquake and tsunami hit Japan on the 11th of March, but the most of the economic impact on UK manufacturers came a month later. The ONS estimates motor viehicle and trailer production to have fallen by 7.1% in April, and has since only picked up by 4% in May (see chart 3).

…the first was the impact of the Japan earth quake and tsunami on the supply of parts to the UK car industry…

Chart 3: Motor vehicle and trailer production

Level of output, 2006=100



Source: Office for National Statistics. Updated 27 July 2011.

Though the car production industry is a relatively small contributor to economic growth (0.3% of total gross value added), we estimate that assuming car production was unchanged in June, then data for April and May suggests the industry could have detracted a tenth of a percentage point from GDP growth in the second quarter.

[5] Goods and services average since 1996.
[6] As reported by the Guardian Online on 6th and 20th of April respectively.

The good news is that both Honda and Toyota expect to make up the short fall in production this year, which means that we should expect better than previously forecast growth for the second half of the year.

…the second was a record warm April…

The second special factor was the unseasonally warm weather in the second quarter. According to the Met Office (the UK's national weather service), April 2011 was the wamest April since records began in 1910, averaging between 3 to 5 °C warmer than normal. Consequently, demand for heating, and therefore also gas and electricity supply was much lower than usual.

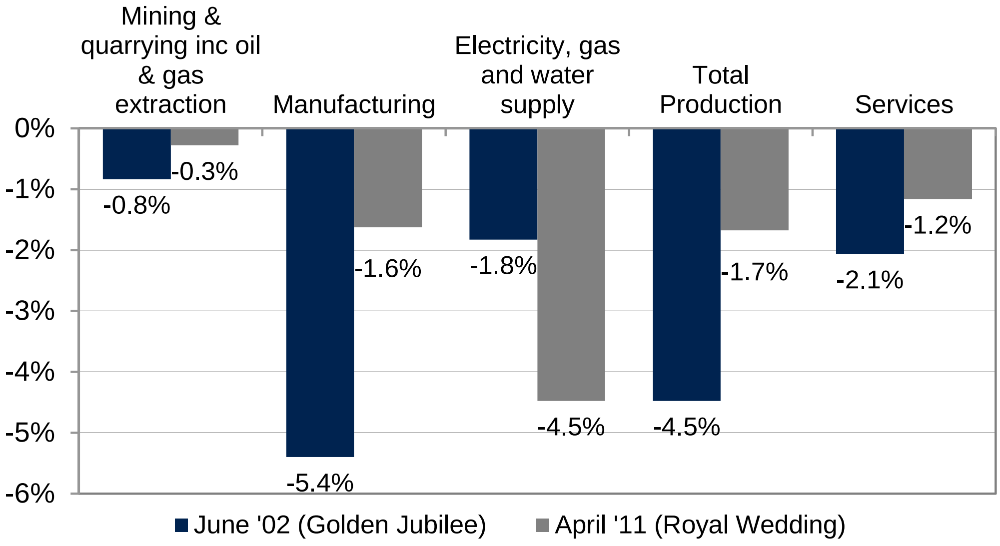
…and finally, the impact of the Royal Wedding Bank Holiday

The final special factor was the extra bank holiday to celebrate the royal wedding of the now Duke and Duchess of Cambridge. It is common practice to adjust for working days in national accounts data, which is why the timing of floating holidays like Easter do not have a major impact on quarterly data (note that the same treatment is not applied to inflation data, hence recent volatility). However, as the extra bank holiday is a special one-off, the ONS has not adjusted for the loss of a working day. This is consistent with what has happened in the past.

The worst possible case scenario would be if the entire economy had stopped working on that day, which means a loss of 1 of the 62 working days in Q2, knocking off 1.6 percentage points from Q2 GDP growth. Clearly, many companies were open for business on the bank holiday, and so the impact would have been smaller.

The last example of this type of holiday was Her Majesty the Queen's Golden Jubilee celebration in June 2002. In fact, when comparing the impact of the latest holiday to that in 2002, we can see that with the exception of the supply of electricity, gas and water (see warm weather explanation above), all other major sub-indices of GDP fell by less than they did in June 2002. For example, manufacturing sector output fell by 5.4% in June 2002, but by only 1.6% in April 2011 (see chart 4).

Chart 4: Comparing impact of special bank holiday (Q/Q growth)



Source: Office for National Statistics. Updated 27 July 2011.

Excluding the special factors, growth would have risen to 0.7% in Q2

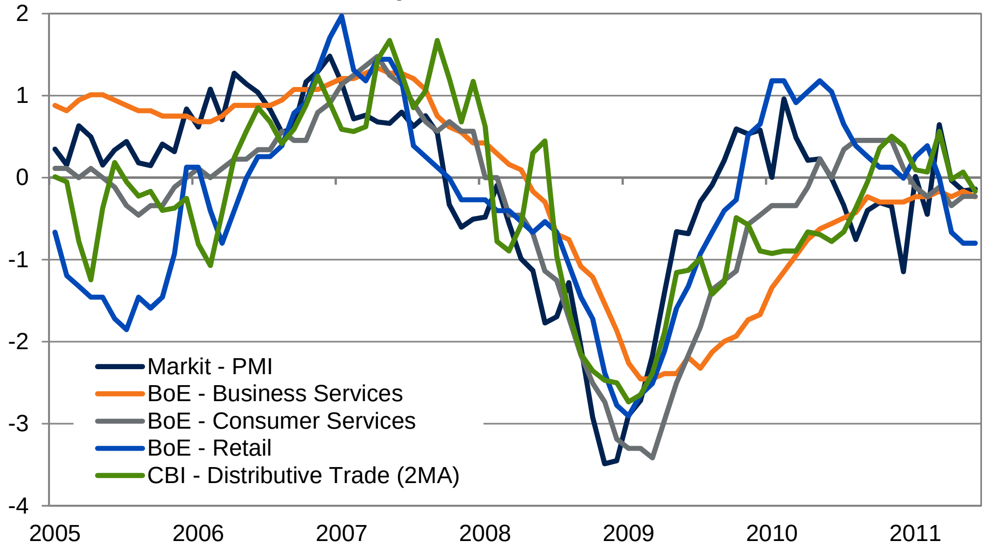
So what is the true state of the UK economy once these special factors have been netted out? The ONS helpfully estimates GDP growth to have actually accelerated from 0.5% in the first quarter to 0.7% in the second quarter had these short term shocks not taken place. Though we only have a consensus estimate of what the actual outcome was expected to be and not what it would have been excluding the special factors, we believe that many city economists would have been surprised by the underlying strength of the economy that the ONS is suggesting.

Surveys still robust

One way to check the state of the economy is to compare survey evidence to official data. For the service sector, most of the monthly indicators available are suggesting slightly below trend growth across the sector, with retail sector survey indicators suggesting the weakest level of activity (see chart 5). However, the range of indicators suggest between -0.2% and +0.2% growth for the three months to June 2011. This is lower than 0.5% Q2 growth estimated by the ONS, though these surveys have consistently underestimated service sector growth recently.

Service sector surveys suggest activity still below trend…

Chart 5: Service sector activity indicators

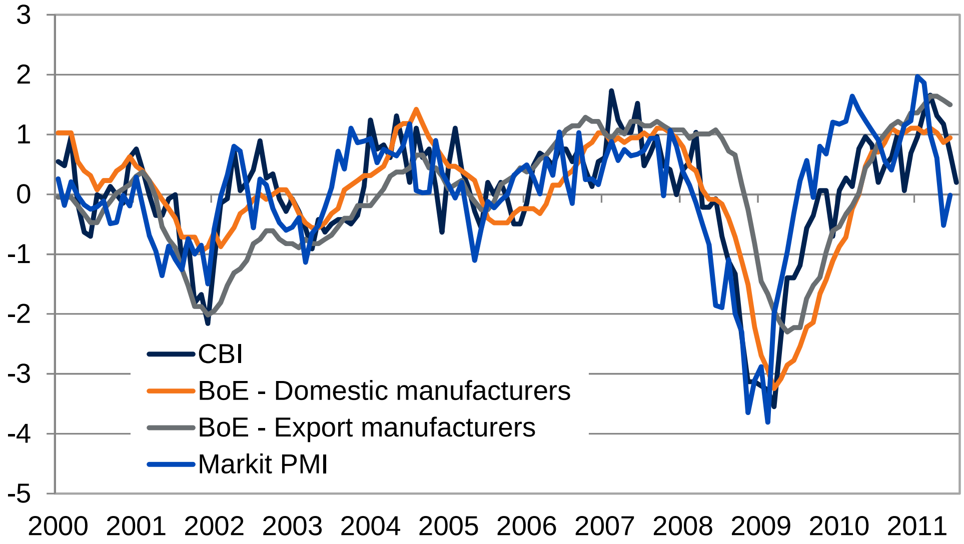


Source: Bank of England Agent scores, Confederation for British Industry Distributive Trade Survey, Markit. Updated 27 July 2011. Standardised numbers since January 2000.

For the manufacturing sector, with the exception of the Markit PMI output index which has recently fallen below its long-run average, the remaining are reporting activity of between 1 and 1.5 standard deviations above their long-run trend (see chart 6). This means the surveys are suggesting growth for the manufacturing sector of between 0% and 1.4% in the three months to June. Compared to the 0.3% estimated by the ONS, this suggests that there could be some upside risk to the official estimate.

…where as the manufacturing surveys suggest slowing, but still robust growth

Chart 6: Manufacturing surveys activity indicators



Source: Bank of England Agent scores, Confederation for British Industry Industrial Trends Survey, Markit. Updated 27 July 2011. Standardised numbers since January 2000.

Looking ahead & policy implications

Looking ahead, we think the weakest in Q2 was caused by temporally factors, and so we expect a stronger H2

With regards to our UK growth forecast, the 0.2% result for second quarter growth was below our 0.4% estimate. However, our analysis suggests that the slowdown in Q2 should be temporary, and that the underlying economy is still making good progress in spite of these shocks. We have therefore not changed our forecast of 2.4% annualised for the second half of the year (0.7% for Q3, 0.5% in Q4). This means that our 2011 forecast as a whole has been reduced from 1.5% to 1.3%, but that our 2012 forecast remains unchanged at 1.9%.

In addition to the special factors discussed above, little attention has been given to the impact of the first phase of ticket sales for the London 2012 Olympics. Though around £300 million worth of tickets have been sold, these have not been counted in the GDP numbers just released. As the payments are for a service due for delivery next year, the ONS has judged it be appropriate to count the payments in the financial account (stock of assets and liabilities), and only record it as a flow (in GDP growth) when the Olympics take place in Q3 2012. This means that service sector and consumption data will be under-representing total spending by households this year, roughly to the tune of 0.1-0.2% of GDP.

We do not expect the government to respond to the slowdown…

In terms of policy response, we believe the government is unlikely to react by slowing the pace of fiscal consolidation. The next forecast update from the Office for Budgetary Responsibility (OBR) is due in the autumn, while the next budget is still some way away. In fact, though we doubt that the reaction would necessarily be to slow down fiscal consolidation. If the OBR is doing its job and the government serious about meeting its fiscal targets, then a downgrading of growth could even warrant more fiscal tightening, not less, despite the risks this would raise of a debt-deflation spiral.

…but the BoE may be more dovish in the near term

Weaker growth may however prompt the Bank of England to be more vocal on its consideration of more quantitative easing. Assuming the Bank agrees with our assessment of the current situation, then it should look through the recent weakness, and opt not to restart its bond purchasing programme. That may disappoint certain members of the current government, but in our view, is the more prudent measure at this juncture.

A final note on the special celebrations, we of course congratulate the royal couple, and look forward to celebrating Her Majesty's Diamond Jubilee in 2012, but an easy way to boost growth would be to temporarily suspend one or more of the eight official annual bank holidays. Though we doubt there will be much support for this idea!

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I. Forecast summary

Real GDP

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	**2.9**	**2.6**	2.5	**2.9**	3.0
UK	4.1	**1.4**	**1.3**	1.5	**1.9**	2.2
Eurozone	23.5	**1.7**	**1.9**	2.0	**1.6**	1.6
Japan	9.5	**4.0**	**0.0**	-0.7	**2.8**	3.1
Australia	1.9	**2.7**	**2.7**	1.9	**3.5**	4.0
OECD	65.4	**2.5**	**1.9**	**1.7**	**2.4**	**2.5**
China	9.1	**10.4**	**9.0**	9.2	**8.5**	8.8
Emerging*	34.6	**7.6**	**6.0**	6.3	**5.5**	6.1
World	100.0	**4.3**	**3.3**	**3.3**	**3.5**	**3.8**

Inflation CPI

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	**1.6**	**2.2**	3.1	**1.4**	2.1
UK	4.1	**3.3**	**4.4**	4.4	**3.1**	2.6
Eurozone	23.5	**1.6**	**2.4**	2.6	**1.7**	1.9
Japan	9.5	**-0.7**	**0.4**	0.3	**0.2**	0.2
Australia	1.9	**2.9**	**3.3**	3.3	**2.9**	2.9
OECD	65.4	**1.4**	**2.2**	**2.6**	**1.5**	**1.8**
China	9.1	**3.3**	**5.0**	5.0	**3.8**	3.9
Emerging*	34.6	**5.2**	**7.2**	6.0	**5.8**	5.3
World	100.0	**2.7**	**3.9**	**3.8**	**3.0**	**3.0**

* **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	0.25	0.45	1.50	1.90
UK	4.1	0.50	0.50	0.91	1.50	1.26
Eurozone	23.5	1.00	1.75	1.71	2.75	1.86
Japan	9.5	0.10	0.10	0.34	0.20	0.36
OECD	63.5	**0.52**	**0.80**	0.93	1.77	1.61
Market data as at		27/07/2011				

Key variables

FX	*Current*	Dec-10	Dec-11	y/y%	Dec-12	y/y%
USD/ GBP	*1.63*	1.60	1.68	5.0	1.60	-4.8
USD/ EUR	*1.44*	1.34	1.45	8.2	1.40	-3.4
JPY/ USD	*78.0*	83.0	81.0	-2.4	90.0	11.1
GBP/ EUR	0.88	0.84	0.86	3.1	0.88	1.4
Brent crude	*119.4*	87.2	113.3	30.0	110.1	-2.9
US output gap %GDP	*-5.6*	-6.4	-4.5		-3.2	
Unemploy. %	*9.1*	9.6	8.5		8.0	

Source: Schroders, Datastream, Consensus Economics, July 2011

Note: Market forecasts of interest rates are based on the LIBOR futures contract.

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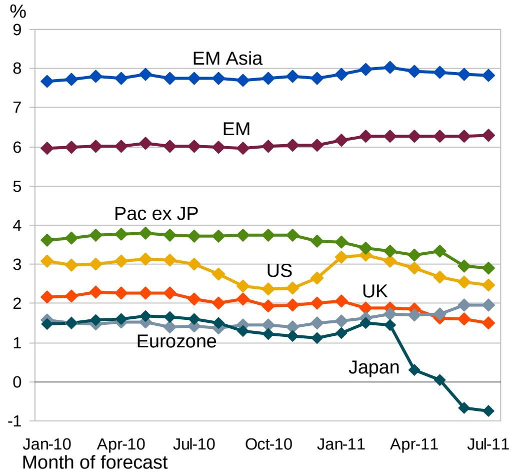
II. Updated forecast charts - Consensus Economics

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

2011



2012

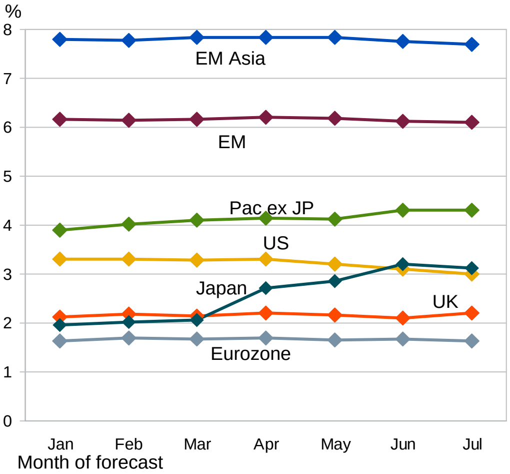
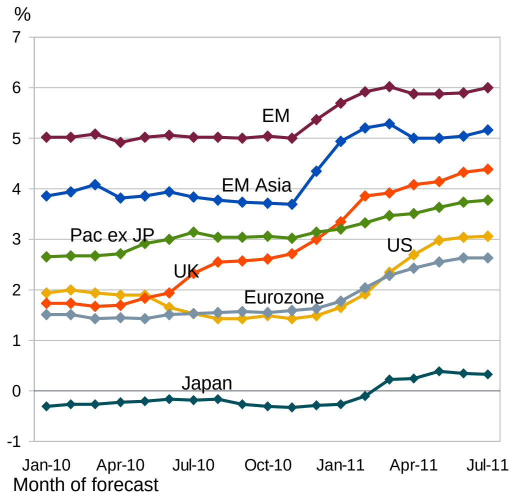
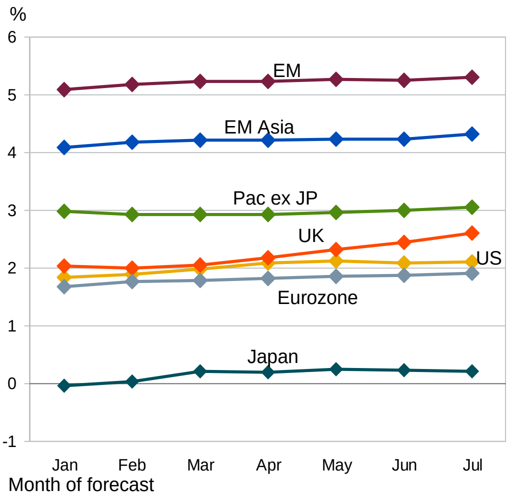


Chart B: Inflation consensus forecasts

2011



2012



Source: Consensus Economics (July 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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