

Schroders

Economic and Strategy Viewpoint

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USD breakout: causes and consequences (page 2)

- Although the latest appreciation in the USD has coincided with a pick up in market volatility, we see the rise in the greenback as an overdue response to divergent monetary policy. The move is reflationary outside the US and favours Japanese and Eurozone equities over emerging markets.
- The danger from a market perspective is that dollar strength combined with weakness in commodity prices causes the Federal Reserve to stay looser for longer, with the risk we see significant bubbles emerging.

UK: Back to business (page 7)

- With Scotland voting to stay as part of the UK, policy makers can turn their attention towards the strength of the economy. Recent official data has remained strong, but leading business surveys are pointing to moderation. Moreover, falling commodity prices could lower CPI inflation significantly in coming months. The Bank of England is expected to raise interest rates early next year, but could a slowdown in growth and inflation prompt a delay?

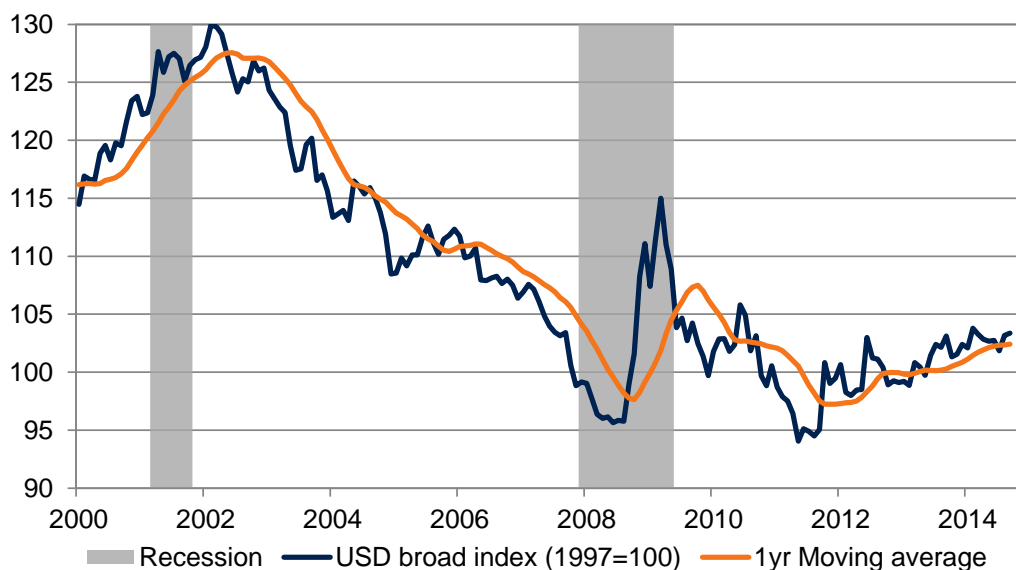
Brazil: Up the Amazon without a paddle (page 12)

- Elections are almost upon us in Brazil, and investors are eager to see a change of government and, they hope, of economic fortune. Yet Brazil faces an array of challenges without an easy or quick solution, whoever wins.

Views at a glance (page 18)

- A short summary of our main macro views and where we see the risks to the world economy.

Chart: Rise of the US dollar – a long way to go?



Source: Thomson Datastream, Schroders, 29 September 2014.

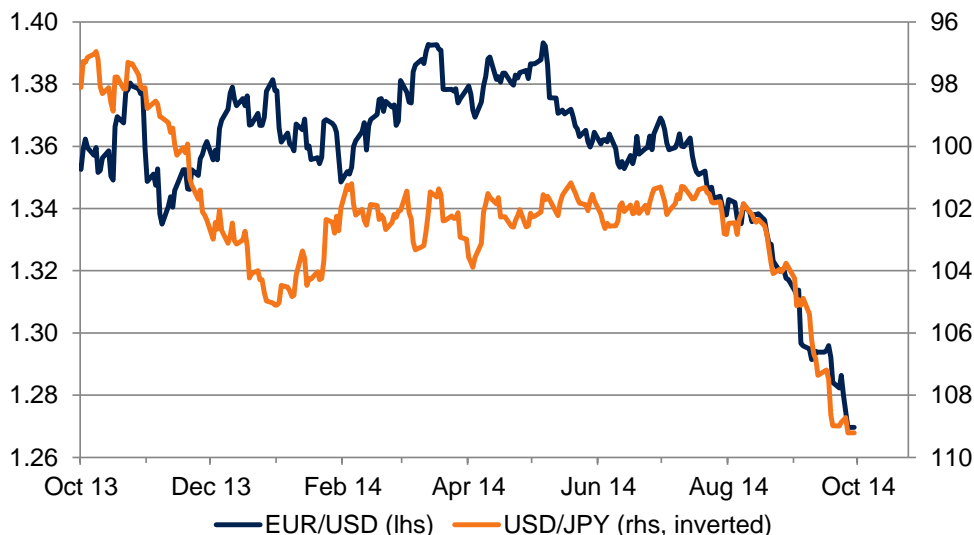


Third quarter marked by surge in US dollar

USD breakout: causes and consequences

After a period of relative stability the US dollar has started to strengthen and has broken higher against the euro (EUR) and Japanese yen (JPY). The euro is now trading at levels last seen in early 2013 while the JPY is back to 2008 values (chart 1). Some see this as a sign that risk aversion is back in markets and that investors are using the dollar as a safe haven. Our interpretation is more benign as the move will help reflate the parts of the world economy which most need support.

Chart 1: US dollar strengthens against euro and Japanese yen

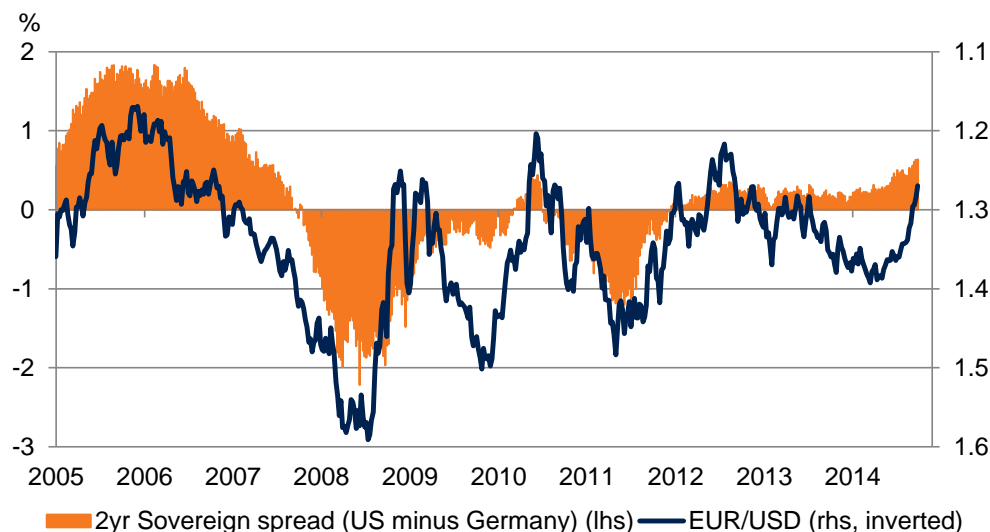


Source: Thomson Datastream, Schroders, 29 September 2014

As the Fed prepares to break ranks with the ECB and BoJ

Whilst the rise in the dollar coincides with the flotation of Chinese online commerce giant Alibaba, which is likely to have drawn significant capital into the US, in many respects it is overdue as a divergence in monetary policy between the US and the rest of the world has been apparent for some time. Policy remains on track with the US Federal Reserve (Fed) set to complete the tapering of bond purchases in October and then indicating higher rates in 2015 through its (in)famous "dot-plot". Meanwhile, the European Central Bank (ECB) has signalled that interest rates will remain low for some time to come, not least to head off the risk of deflation. These expectations are captured in the spread between two year government bonds in the US and Germany, which has increased to its highest level since 2007 (chart 2).

Chart 2: US-German spreads: yield to the dollar



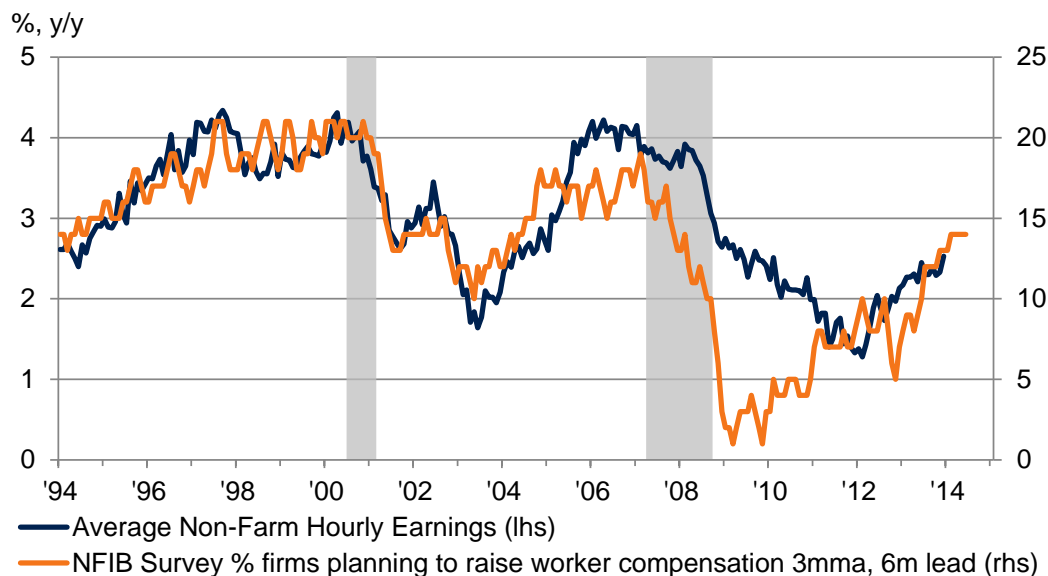
Source: Thomson Datastream, Schroders, 25 September 2014

Against the JPY, interest rates play less of a role, but the move can be seen in the same light with the recent weakness in the Japanese economy expected to bring forward additional easing by the Bank of Japan (BoJ). It is still our contention that the principal transmission mechanism for Abenomics is through the currency and we are waiting for the BoJ to step up asset purchases and push JPY lower.

Clearly, higher US rates are a key driver of a stronger dollar view and although we do not intend to revisit the case for higher US rates (a thorough analysis is contained in previous Viewpoints), suffice to say that recent indicators continue to point to a tightening of the labour market and pick up in wages. For example, the proportion of firms planning to increase worker pay remains elevated, signalling acceleration in wages (chart 3).

Chart 3: Survey points to stronger US wage growth

US labour market remains key for Fed - we see further tightening

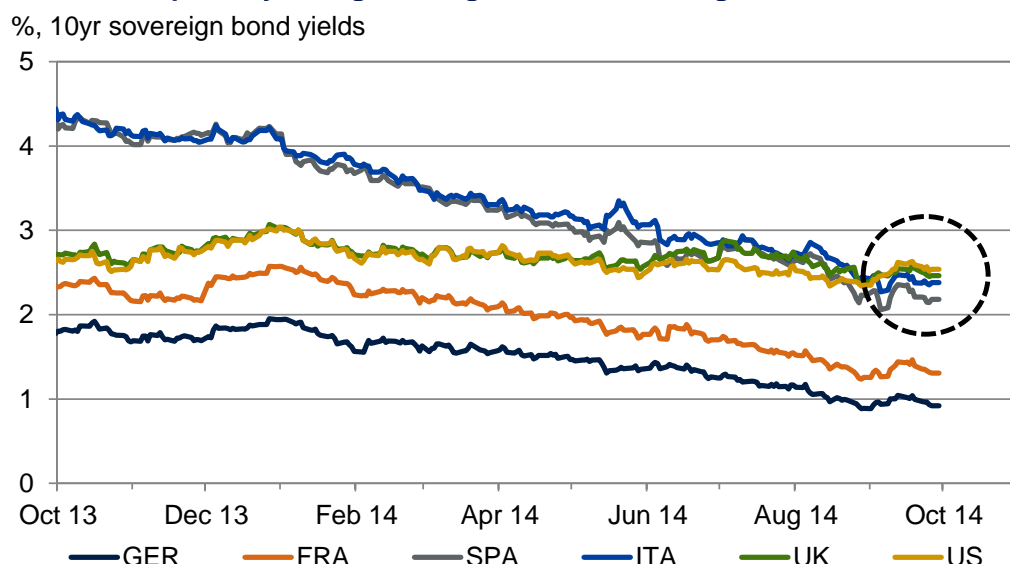


Source: Thomson Datastream, Schroders 29 September 2014

One factor which has received little attention in the decline in EUR is the convergence of bond yields across the currency zone. International investors have been active participants in the convergence trade between periphery and core as the tail risk of euro break-up has faded. Clearly this is a positive development and there may still be an opportunity in this trade, however the risk-reward has become less attractive and the two largest peripheral markets (Italy and Spain) have both traded through the UK and US (chart 4). Rather than outside investors, demand for peripheral bonds is now being driven by Eurozone banks flush with liquidity from the ECB, but facing little private sector demand for credit.

Eurozone bonds less attractive as yields fall below US and UK

Chart 4: Peripheral yields go through Treasuries and gilts



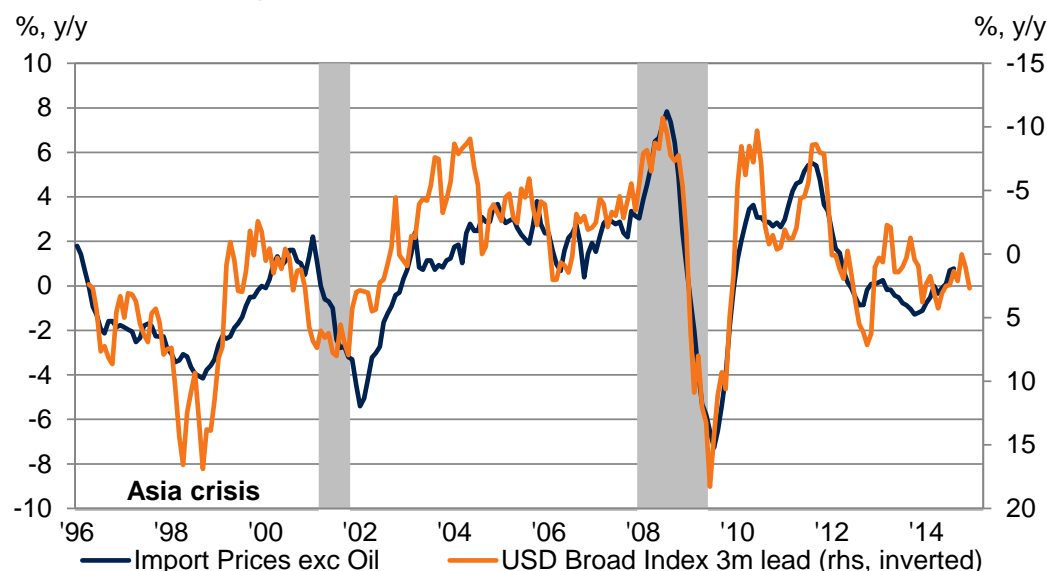
Source: Thomson Datastream, Schroders. 29 September 2014.

Some implications of dollar strength

It could be argued that by acting as a deflationary force, a stronger USD will reduce inflation and the need for tighter policy from the Fed. In this respect the rise in the dollar would become self defeating as it would reverse the forces which had driven it higher in the first place. At this stage we would discount such an effect as although the stronger currency will depress import prices, the move has not been great enough to have a significant impact on prices. This could change should the dollar continue to rise, but at this stage deflationary pressure is far less than during the Asia crisis or the past two recessions (chart 5).

Move in dollar will help contain inflation, but is not as deflationary as in the past

Chart 5: Trade weighted dollar and import price inflation in the US

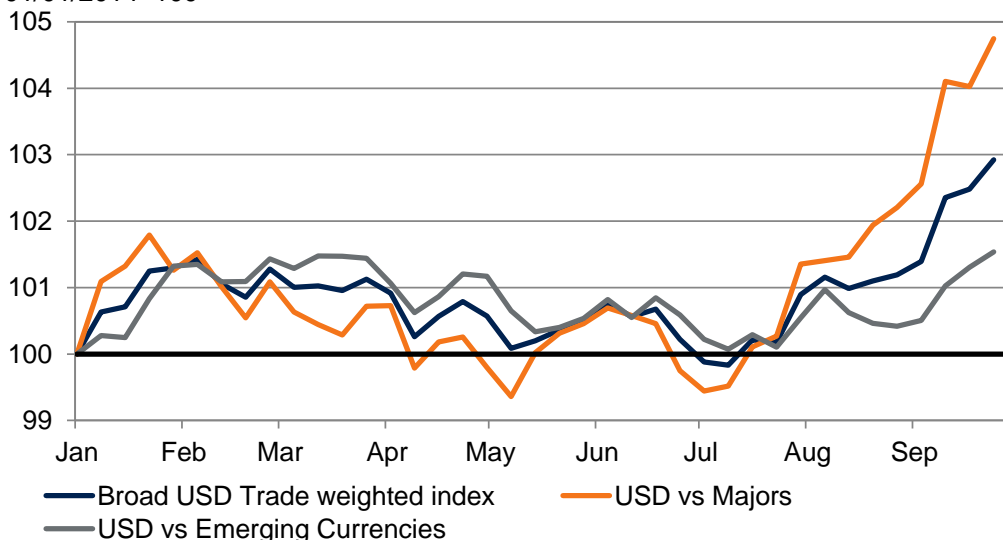


Source: Thomson Reuters Datastream, Schroders 29 September 2014

The chart highlights an important feature of the recent move as on the broad Fed index, the dollar move has been less significant than versus EUR and JPY. This largely reflects the effect of the emerging market currencies which comprise 56% of the index (China accounts for 21% of the total index) and have moved less than the majors (chart 6).

Chart 6: USD strength has been against the majors

01/01/2014=100

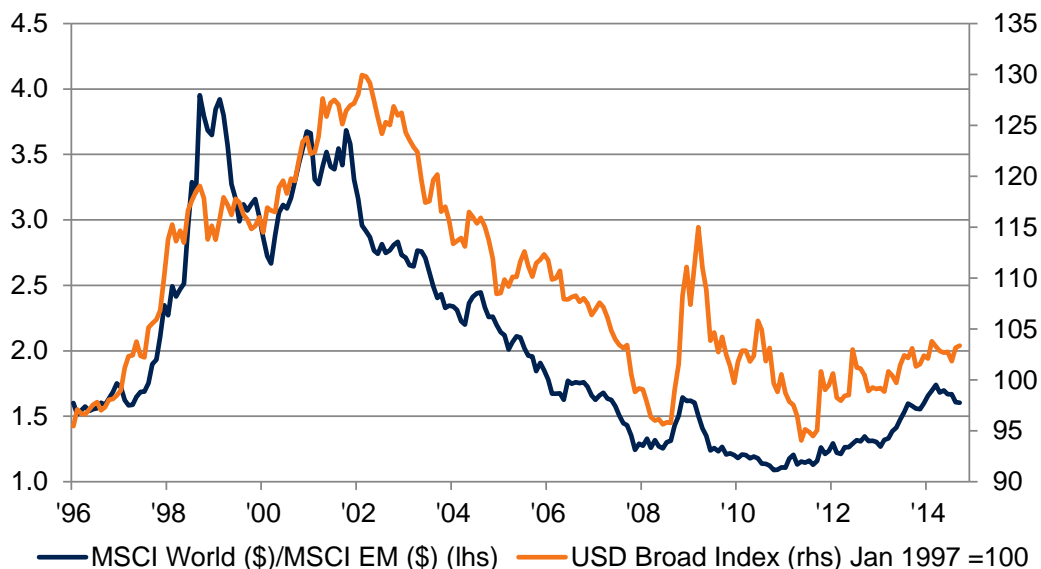


Source: Thomson Reuters Datastream, Schroders 29 September 2014

Pressure on EM likely

Consequently, the emerging economies will have appreciated against the majors, a factor which will weigh on their competitiveness versus the likes of Europe and Japan. Dollar strength has always been a concern to the EM countries given their links to the currency which transmits any tightening by the Fed to their economies through changes in reserves. In addition, the commodity producers are vulnerable as oil, metals and agricultural prices tend to move inversely with the dollar. These factors are reflected in the underperformance of emerging against developed equity markets during periods of USD strength (chart 7). The flipside is that Japanese and European equities benefit from a stronger dollar.

Chart 7: Stronger USD weighs on emerging v. developed equity markets



Source: Thomson Reuters Datastream, Schroders 29 September 2014

Japan and Europe benefit, through equities more than growth

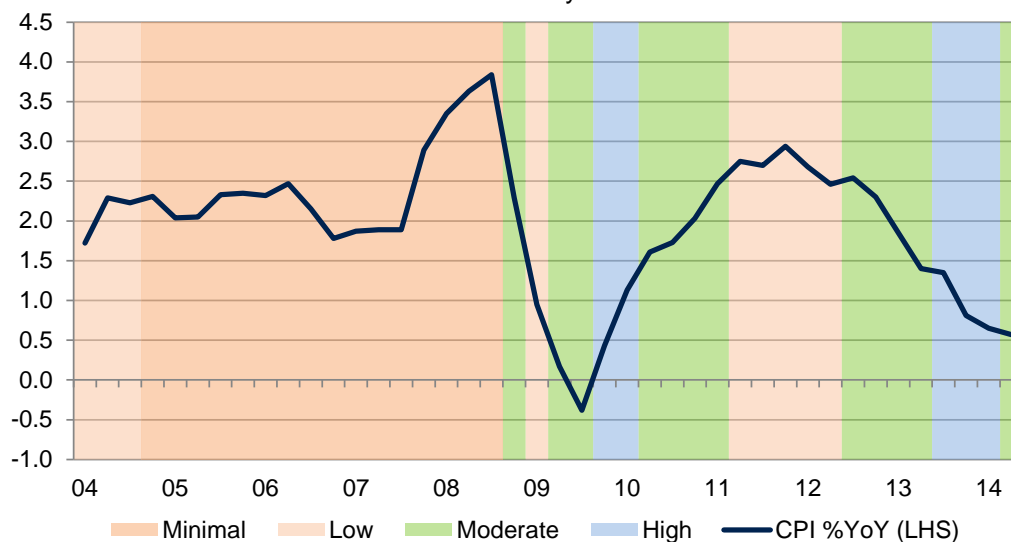
It should be said that the benefits to European and Japanese firms primarily come through the translation effects of overseas earnings, rather than better export growth. Hence a weaker currency boosts the stock market more than the economy in the near-term as better trade performance takes time to come through. Such an outcome can be seen in Japan where the equity market has rallied on JPY weakness, but net exports have been lacklustre. There is a similar pattern in the UK where the devaluation of GBP seems to have brought little benefit to trade performance. The initial benefit of currency depreciation is felt through better profit

margins and the benefit of a more competitive currency can take a long time to come through as firms are unwilling to adjust their production processes unless they believe the new level can be sustained.

Nonetheless, the reflationary effects of a weaker euro will be welcomed in a Eurozone economy where conventional monetary policy is proving ineffective. For example, our deflation vulnerability index has moved from high risk to moderate risk as a result of the EUR move which translates into a reduction in the probability of deflation from 25% to 14%.

Chart 8: Risk of deflation in the Eurozone reduces

Eurozone CPI %YoY and Deflation Vulnerability Indicator



Vulnerability indicator as of Q2 2014. For more details on the methodology, see the May 2014 Economic and Strategy Viewpoint. Source: IMF, Thomson Reuters Datastream, Schroders. 9 September 2014.

USD strength: cause for concern?

We would see the rise in the USD as a reflection of the stronger performance of the US economy relative to weak performance elsewhere, rather than a sign of increased risk aversion in the financial markets. In the past we have seen strong moves in the dollar when volatility rises and investors flee risk assets, such as equities and credit, for the safety of the dollar. This was the pattern in the global financial crisis. However, today although equities and credit have been softer of late, dollar strength has not been accompanied by a rally in US Treasury bonds or for that matter gold, the other safe haven of choice.

More like late 1990s than the global financial crisis

In our view, rather than risk aversion, the greater risk is that the environment could become like that in the late 1990s when the Asia crisis delayed the Fed tightening cycle as fears of deflation caused the then Fed Chairman Alan Greenspan to delay the tightening cycle. The result was an extended period of liquidity which ultimately fuelled the bubble in technology stocks. Should further dollar strength combined with commodity weakness keep inflation low, a dovish Yellen Fed may delay tightening. The result could be another financial market bubble. That is the risk.

At this stage the deflationary forces are more modest than in the late 1990s and we have seen nothing like the surge in the dollar which accompanied the Asia crisis. This may change if the dollar continues to rally and investors need to be more selective about equity allocation: preferring Japan to emerging market equities, for example. Overall though, the world economy must welcome the recent moves in currency markets as they provide support to the Eurozone and Japan, the parts of the world which most need reflation.

UK: Back to business

The still UNITED Kingdom is getting back to business. After months of political uncertainty, Scotland voted to remain as part of the UK's political union, and by a larger margin than expected. The focus now turns to the strength of the economy, and whether the Bank of England will start to normalise monetary policy in the near future.

Political risk defused

Relief amongst investors as Scotland votes to remain as part of the UK

There was a collective sigh of relief amongst City economists and investors who had risen early to hear the results from Scotland's referendum on independence. In the end, the victory of the pro-union camp was wider than most of the polls had suggested. With an enormous turnout of 84.6%, Scotland backed the union by 55.3% to 44.7%. The immediate reaction was a bounce in GBP against both the USD and EUR, but also a rise in prices of stocks that are either Scottish-based, or with significant business in Scotland. The prospects of months of messy negotiations, uncertainty over the division of national assets and debt, and the currency arrangements of an independent Scotland had been weighing on the confidence of investors over the past few weeks, especially as polls had tightened.

Westminster is now expected to devolve more power to Scotland after a late promise by the leaders of the major Westminster parties. Variability in tax rates may introduce distortions at a micro level, but should have little impact to the overall macro economy.

Following the result, Prime Minister David Cameron also vowed to tackle the issue of the 'West Lothian' question - in reference to the lack of devolved power to England. As Scotland, Wales and Northern Ireland have their own parliaments/assemblies, English members of parliament in Westminster cannot vote on policy changes where power has been devolved to those regional authorities. However, members of parliament not from England can and often do vote on English only issues, which raises the question of fairness. The exact route to better representation for English voters is unclear, but further constitutional reforms appear likely.

With political risk defused, policy makers can focus on the economy, and potentially raising interest rates in 2015

Returning to the issue of Scotland, the referendum result along with further devolution should mean that another referendum is very unlikely in the foreseeable future. However, long-term investors will be minded of the risk of separation and may demand a premium for undertaking fixed asset investments in Scotland going forward.

Continuation of the union also means the risk of the UK's exit from the European Union (EU) has been reduced, although it does remain significant. Scottish residents are more in favour of remaining in the EU, compared to the rest of the UK where the majority favour an exit. Overall, major disruption has been avoided and focus can now return to the state of the economy, and the potential start of the next interest rate cycle.

Growth remains strong, but likely to moderate

UK official data continues to point to strong growth, recently aided by higher business investment...

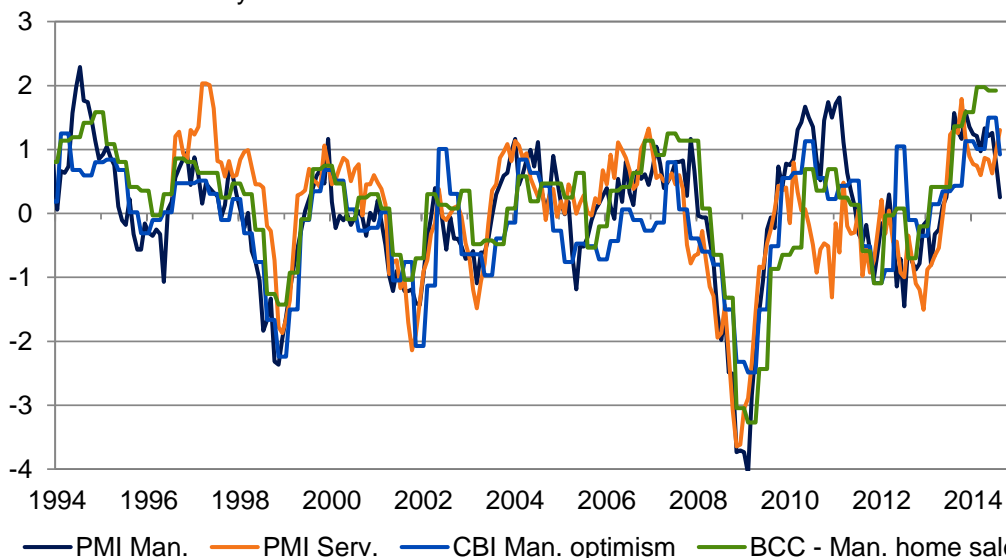
Recent official data suggests the economy has continued to perform strongly over the summer months. Industrial production grew by 0.5% in August, taking the annual growth rate to 2.7%. This was significantly stronger than in recent years, where industrial output had seen negative growth of -0.4% in 2013 and -2.4% in 2012. Meanwhile, the volume of retail sales was up 4% in August on a year-on-year basis - significantly higher than the rates of growth recorded in 2012 (1.5%) or 2011 (1%).

The surge in UK growth started in the middle of 2013, and has been uninterrupted for the best part of a year. The spark appears to have been the government's housing finance initiatives, which were successful in reducing the cost of new mortgages, along with increasing the availability of financing. The improvement in housing activity brought along associated spending, such as on legal services, estate agents, furniture and so on. Coupled with a rise in hiring across the economy, the multiplier effect has been building for some time. Household consumption continues to be the engine of UK growth, but the acceleration in business investment has also played an important role.

In this context, it is concerning that although official data continues to be strong, some of the available business surveys have started to slow. The manufacturing PMI has fallen in recent months, while the CBI's Industrial Trends Survey is also reporting some moderation in business sentiment (chart 9).

Chart 9: Business surveys peaking

Standardised survey balances



Source: Thomson Datastream, Markit, British Chambers of Commerce, Confederation of British Industry, Schroders. 26 September 2014.

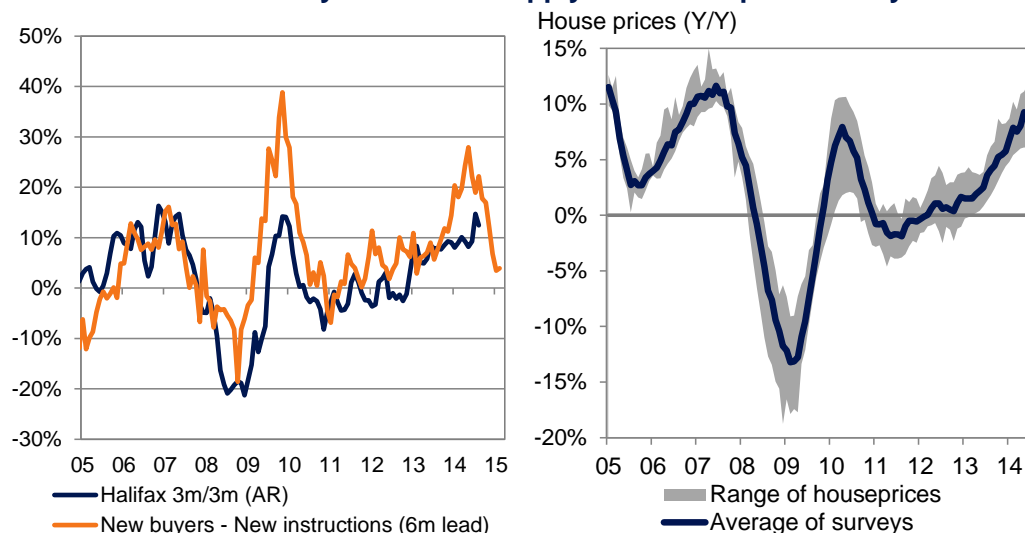
Europe, the UK's biggest trading partner, has experienced a more visible slowdown so far this year, which will be having an adverse impact on some firms. Similarly, sanctions on Russia may also be playing a role, although trade with Russia is small. However, there are also domestic factors that should be considered.

The first is the slowdown in the housing market. Following the Bank of England's introduction of the Mortgage Market Review (which forces banks to take greater responsibility in checking the suitability of mortgages for borrowers), the Royal Institute for Chartered Surveyors (RICS) began to report a slowdown in activity. The pattern is not uniform across the country, but in aggregate, the ratio of sales to stock of property has been falling. Moreover, the ratio of new buyer enquiries to new instructions (sellers) has also been falling sharply (chart 10). Both ratios are good leading indicators of future price action, which is why RICS is also reporting a reduction in expected house price inflation from their members.

Look at the range of house price indicators (both asking and agreed), it does appear that house price inflation is beginning to moderate, although the average of the range of surveys still shows 8.2% growth compared to a year earlier (chart 11).

The housing market also appears to be cooling...

Charts 10 & 11: New buyers vs. new supply and house price surveys



Source: Thomson Datastream, Halifax, Nationwide, Rightmove Hometrack, LSL/Acadametrics, ONS, Schroders. 29 September 2014.

...while the hiring is also slowing.

The second factor to consider is the slowdown in the labour market. Wage growth continues to be very subdued in nominal terms and very negative once adjusted for inflation. However, this has been over-ridden by the strength in hiring, which with a rise in average hours worked, raised the household sector's aggregate income. Employment of those aged 16+ has risen by 774,000 in the 12 months to July 2014. However, the last three months (May-July) only saw employment rise by 74,000 - less than 10% of the annual figure. Moreover, just 5,000 of the 74,000 workers were full-time workers. The slowdown in hiring may turn out to be a temporary soft-patch, but for now, it does fit with a wider moderation in economic activity.

The Bank of England will have to be confident that these early signs of a slowdown will not escalate into a more significant slowdown if the Monetary Policy Committee (MPC) is to push ahead with raising interest rates early next year. Its assessment of momentum, along with the amount of economic slack, will be key, which unfortunately is not being aided by the Office of National Statistics (ONS) 'upgrading' the methodology used to measure the national accounts (see box 1).

Box 1: Sex, drugs, and GDP revisions

The annual release of the Blue Book is usually a quiet affair that passes by most investors as a non-event. The annual publication is used to rebalance data to improve consistency between sectors along with the inclusion of new information from annual surveys. However, the latest release due next month includes sweeping revisions which will re-write the history of the financial crisis and subsequent recovery - at least in GDP terms. The National Accounts are being brought into line with European Standards, including the inclusion of illicit activity.

The ONS has already published a preview of some of the data revisions due to be implemented and included them with the latest GDP release. The most significant impact of the revisions is the profile of the economy before and after the financial crisis. Growth in 2007 has been revised down from 3.4% to 2.6%, however, the fall in GDP in 2008 has been reduced - GDP fell from peak to trough by 7.2% in previous estimates, but revised data show a smaller 6% fall (chart 12). Also, the return to the pre-financial crisis peak in GDP has now estimated to have been faster - three quarters earlier. The new data also shows that the economy has surpassed that peak by 2.7% in the second quarter of 2014, compared to by just 0.2% using the previous data. This is important as it suggests the economy may have less spare capacity available, and may be closer to the point where it begins to generate higher inflation - which also suggests the Bank of England would be forced to raise interest rates faster than

previously thought. All things equal, the output gap would indeed be smaller, however, the revised data could also lead to changes in assumptions to potential growth. The Bank of England assumes that growth in potential output may have been constrained during the financial crisis, and indeed may have even been negative for a short while. The data revisions may now lead the Bank to change its assumptions on potential output, in that, it may not have been as badly affected as previously thought. Therefore, investors should wait for the Bank of England's full assessment on slack, which is likely to be updated in the November Inflation Report. This would be prudent given the Bank's tendency to change its key assumptions.

Chart 12: GDP growth revisions

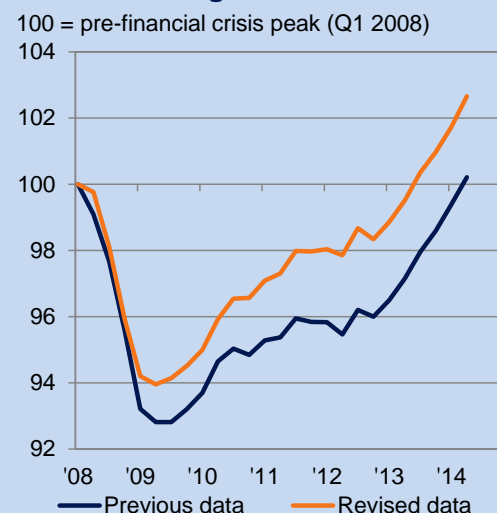


Chart 13: Contributions to GDP revisions

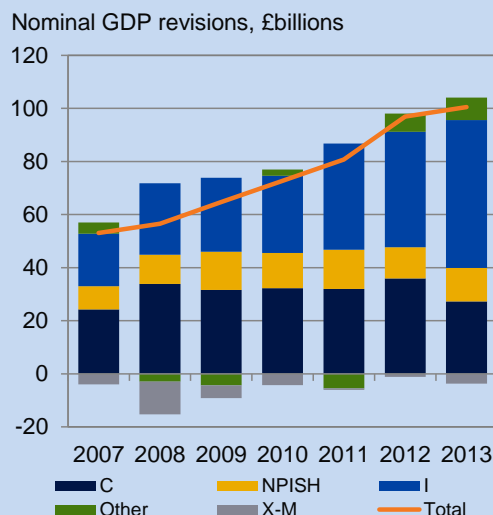


Chart on the left shows real GDP using the previous data and the ONS's new revised data. The chart on the right shows contributions to nominal GDP revisions. Source: ONS, Schroders. 30 September 2014.

One point to note is that most of the changes to the data are being driven by changes to the methodology for certain areas, rather than areas that are monitored by business surveys. For example, non-profit institutions serving households (NPISH) are now being accounted for using an updated methodology, which is adding about £11.8 billion to 2013 nominal GDP. Business investment has been revised up by £55.7 billion, with a major change in the way investment in intangibles is accounted for. Investment in R&D, advertising, training etc., will no longer be counted as business consumption, but rather investment, which will raise the UK's capital stock, and will also help solve the UK's 'investment puzzle' (why investment as a share of GDP is so low). In addition, corporate investment in weapons has been reclassified, making a contribution. Household consumption is being revised up by £27.3 billion, with most of the revisions caused by the inclusion of the consumption of illegal drugs and prostitution. In 2013, £5.8 billion was attributable to prostitution, while narcotics were worth £6.7 billion. How the BoE treats the inclusion of illicit activity is unclear, but it will note that the growth in these sectors helped raise the profile of GDP during and after the financial crisis.

Finally, as nominal GDP is being revised up by £100.5 billion from 2013 (6.2%), national debt as a share of GDP should be lower. A number of other ratios will also be affected, although revisions are also being made to what is included in the public deficit, which could make it also larger.

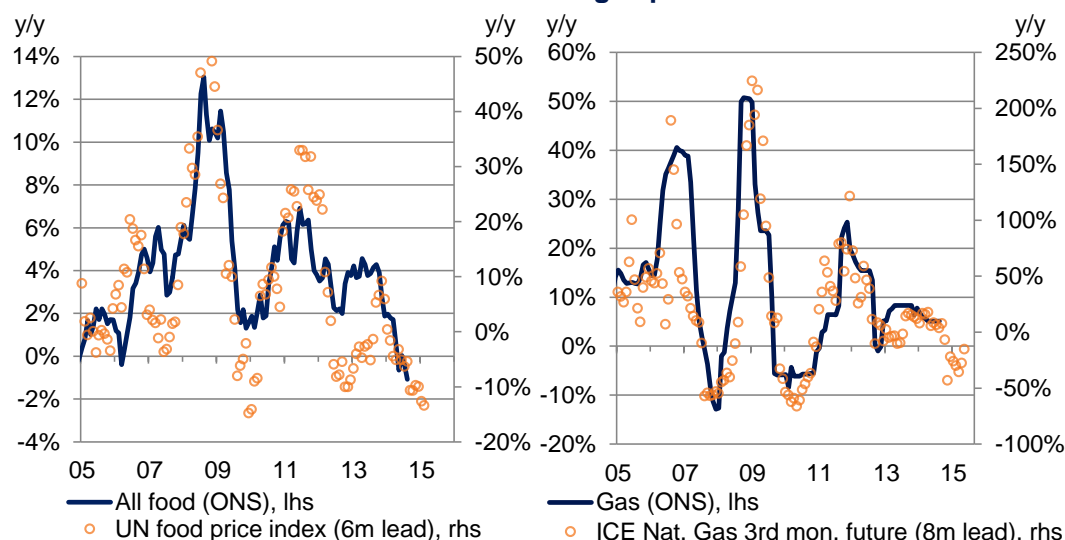
Lower inflation could delay rate hikes

Aside from the odd seasonal surprise, UK inflation has been fairly well-behaved in recent months. Headline annual CPI inflation was 1.5% in August, although core inflation (excluding food, energy, alcohol and tobacco) is running higher at 1.9%. Like most of Europe, the more volatile food and energy sub-indices have been a drag on headline inflation since the start of the year. Unless the economy is flirting with deflation, softer commodity price inflation is usually a positive development as it boosts the purchasing power of households and corporates.

However, in managing inflation expectations, the Bank of England will not want the headline rate to fall too far. Commodities have been under pressure all year due to over supply and weakness in global demand, along with the trend in the USD (see global section). For example, the price per barrel of oil using the Brent Crude index is currently under \$98, compared to a peak of just over \$115 earlier in June and \$108 a year ago. In addition to the fall in oil prices, food price inflation has been very low, while the price of natural gas in Europe has fallen sharply following the unusually warm winter at the start of the year. It can take months for the impact of falling wholesale prices to be passed on to end users, which suggests that food and energy price inflation may have further to fall heading into 2015 (see charts 14 and 15).

Low inflation may be another challenge the BoE faces

Charts 14 & 15: Wholesale food and natural gas price vs. ONS sub indices



Source: Thomson Datastream, UN Food & Agriculture Organization, ONS, Schroders. 26 September 2014.

Lower inflation, even if caused by commodity prices falling, raises the risk that the Bank of England delays raising interest rates early next year. If the headline inflation disappoints the BoE's forecast, the MPC may decide that it would be too difficult to explain why interest rates need to rise when inflation is so low. If supermarkets continue to compete aggressively on prices (as they have been recently) and if energy companies pass on the full savings from falls in wholesale prices to households (not typical) then we could see headline inflation close to 1% by February 2015.

Low inflation, softening housing market and business activity, and a weak outlook the UK's biggest export partner could prompt the MPC to maintain a dovish view. Indeed, money markets have reduced pricing on rate hikes for next year to around 75bps of hikes over 2015. The MPC will face a trade off between starting to normalise policy with early but slow hikes to minimise the impact on the economy, or wait until there is more certainty on the strength of the economy. The reduction in political risk helps policy makers enormously, but in returning focus on the economy, other risks are manifesting.

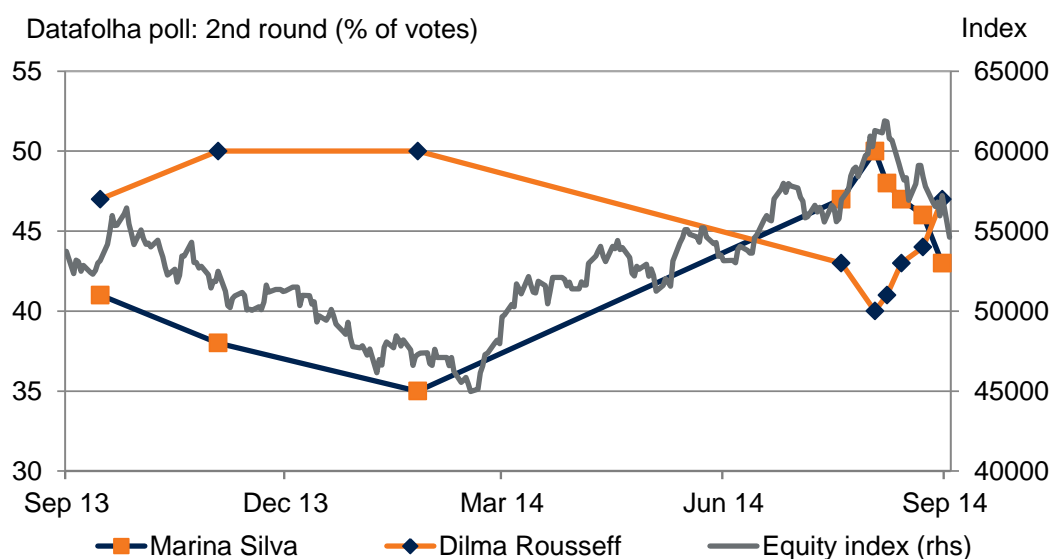
Brazil: Up the Amazon without a paddle

"Anyone but Dilma" sentiment among investors...

Elections loom in Brazil, with the first round of voting taking place on the 5th of October (a second round will take place on the 26th if no candidate wins an outright majority, but only the two highest placed candidates will stand). The presidential race had looked almost certain to return the incumbent, Dilma Rousseff, until the death of socialist party candidate Eduardo Campos in a plane crash in August.

Subsequently his running mate, Marina Silva, came to head the socialist ticket and the polls, with voters preferring her to Rousseff in a second round run-off. The prospect of a Rousseff defeat tantalises investors, and the market has rallied on any news suggesting the likelihood of such an outcome has increased. Terrible economic data and a fall in the polls for Dilma have both been met with a positive market response; the index is up almost 20% since its first half low (chart 14), though this marks an unwind of 13% from recent highs as poll data has disappointed.

Chart 14: Hopes of a Dilma defeat driving market performance



Source: Datafolha, Thomson Datastream, Schroders. 29 September 2014. Note that there is no poll data between February and August comparing the two as Silva dropped out of the race temporarily. Instead we have interpolated between the two points.

However, polls are now tightening with the latest placing Rousseff and Silva neck and neck in the second round. This follows a barrage of attacks on Silva by most other candidates, including both Rousseff and Aécio Neves, and former president Lula. The attacks have also seen Silva's rejection rate (voters saying they would never vote for her) rise to 22%, nearly double the rate a month ago, against Rousseff's 33%. The market impact has been predictable.

Treacherous currents tug at Brazil

...but is it justified?

A question worth addressing at this point is why are markets so keen to see Rousseff go? Most readers probably recall Brazil's inclusion in the Fragile Five at the time of the "taper tantrum" in May 2013. This reflected, at least in part, the country's weak economic fundamentals; high household borrowing, a large current account deficit, suspect fiscal practices, high inflation, and so on. In fairness, Brazil actually looked stronger than its fragile peers in many respects, but nonetheless the BRL depreciated sharply following Bernanke's comments on QE tapering.

Some policymakers in EM took this as a sign that reforms were needed. In India, in particular, the new central bank governor has been working hard to address the balance sheet problem and build up reserves, while the new government is pushing ahead with reform. Efforts are also being made in Indonesia, another of the Fragile Five. Yet Brazil, in common with Turkey, has made little or no effort to reform. Instead, the breathing space yielded by the current market calm has been used to provide more of the same, and as a result we have seen no improvement in fundamentals. This has come alongside repeated promises from Dilma to implement reforms and claims that the economy is strong, and investors have lost patience.

Policy efforts to address balance sheet issues have been lacking

Table: Twin deficits in EM

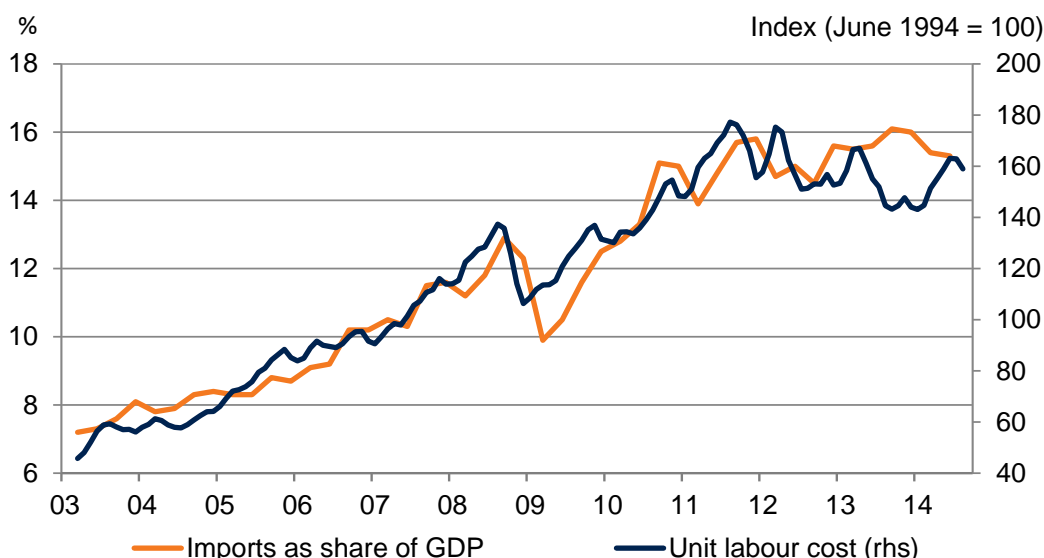
	Country	CA position (% GDP)	Change in CA position, yoy (pp)	Fiscal position (% of GDP)	Change in fiscal position, yoy (pp)
Twin deficits, both worsening	Colombia	-3.5	▼ -0.2	-2.7	▼ -1.3
	Czech Rep	-0.4	▼ -0.5	-4.4	▼ -1.1
Twin deficits, mixed performance	South Africa	-6.2	▼ -1.7	-4.9	▲ 0.7
	Brazil	-3.8	▶ 0.0	-3.4	▼ -0.6
	Indonesia	-3.2	▲ 0.0	-1.7	▼ -1.0
Twin deficits, both improving	Poland	-0.9	▲ 0.4	-3.9	▲ 1.1
	Turkey	-6.6	▲ 0.9	-1.1	▲ 0.6
	India	-1.9	▲ 0.9	-5.1	▲ 0.8
Single deficit	Mexico	-1.2	▲ 0.3	-2.3	▲ 0.3
	Peru	-5.3	▼ -0.2	2.1	▲ 0.1
	Chile	-2.4	▲ 0.7	0.6	▼ -0.8
	China	1.7	▲ 0.2	-2.2	▼ -0.9
	Thailand	3.4	▲ 1.8	-2.7	▼ -0.4
	Russia	2.5	▲ 0.7	-0.5	▼ -0.2
	Hungary	3.0	▲ 0.7	-2.0	▼ -6.2
	Philippines	3.6	▲ 0.1	-1.4	▲ 1.0
	Malaysia	5.9	▲ 1.3	-4.5	▼ -0.8
Taiwan	12.9	▲ 0.4	-1.6	▲ 0.3	
No deficits	South Korea	6.4	▲ 0.0	1.9	▲ 0.1

Source: Bloomberg, Thomson Datastream, Schroders. 29 September 2014. Larger arrows indicate a change greater than the average change in that direction. Small arrows indicate a below average change. Note that some fiscal data is released only on an annual basis.

Structural problems need to be resolved

As can be seen from the table above, Brazil has made little progress in addressing its current account deficit. The reasons for this are varied. A reliance on commodities as an export driver at a time when Chinese demand is faltering and prices soft has not helped the export picture. Those sizeable current account deficits remain in other commodity exporters like South Africa and Indonesia also speaks to this. In addition, Brazil has lost a lot of competitiveness, as measured by the unit labour cost, hurting exports and boosting imports as producers struggle to compete (chart 15 on next page).

Chart 15: Poor competitiveness impacts the trade balance



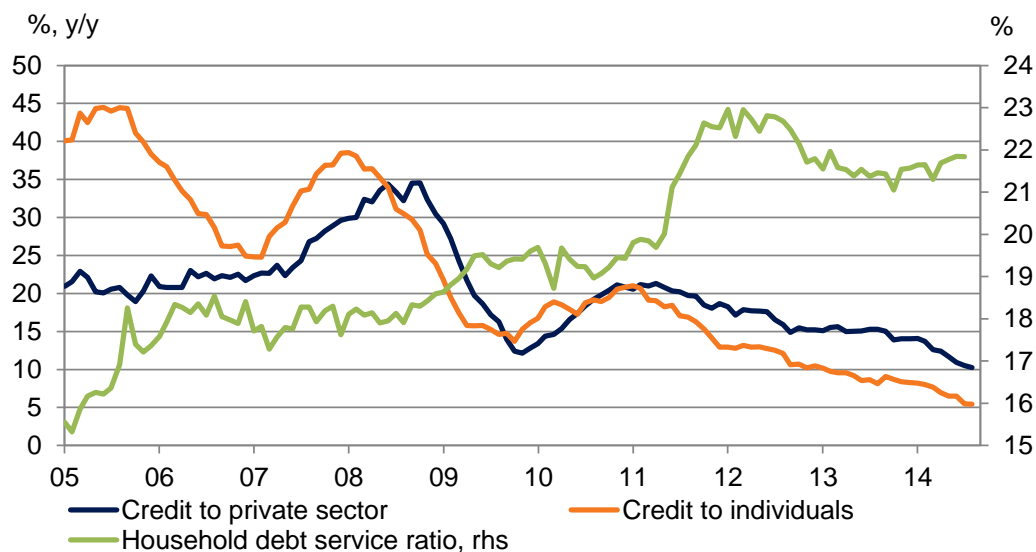
Source: Thomson Datastream, Schroders. 29 September 2014

Reliance on the consumer for growth has created a debt problem

Imports are also falling less than expected despite the weaker Brazilian real (BRL), in part because of continued credit growth and minimum wage increases providing support to demand. This raises another point - household debt now represents some 44% of annual income, or 30% excluding mortgages. The cost of servicing debt now accounts for around 22% of income (chart 16). The net result is that household balance sheets are very sensitive to housing prices and changes in income growth. Given that consumer credit is about a quarter of bank loan books, the chance for a systemic impact here is obvious. Tighter monetary policy should limit further expansion but a policy rate of 11% could also see defaults climb.

Note also that this is not the only problem facing the financial system, which as a whole has witnessed a decade long credit boom, pushing private credit: GDP up by 60 percentage points. The rapid increase has also undermined the solvency of the system; the credit: deposit ratio has risen from less than 70% to in excess of 100%. This both builds financial vulnerability and limits the scope for further credit expansion in support of growth. A considerable deleveraging is needed, but government policy continues to promote the opposite; via the national development bank (BNDES) Brazil pushes subsidised credit out to industry, in a way that favours the larger firms.

Chart 16: Credit growth slowing in the face of painful debt costs



Source: Thomson Datastream, Schroders. 29 September 2014

Subsidies for corporate credit have worsened the fiscal outlook

The BNDES lends at a highly subsidised rate of just 5%, funded by the government at a rate of 11%. There are at least two negative consequences of this arrangement. One is that the provision of subsidies has allowed the BNDES to dominate the long term credit market, and so driven capital misallocation through this monopoly and also the mispricing of credit. The other is that the gap between the rate at which funds are loaned and borrowed is proving costly to the state's coffers. This is not reflected in the headline fiscal budget numbers, however. The government excludes BNDES funding from its calculations (but includes dividends it takes from the bank). This brings us neatly to the next problem.

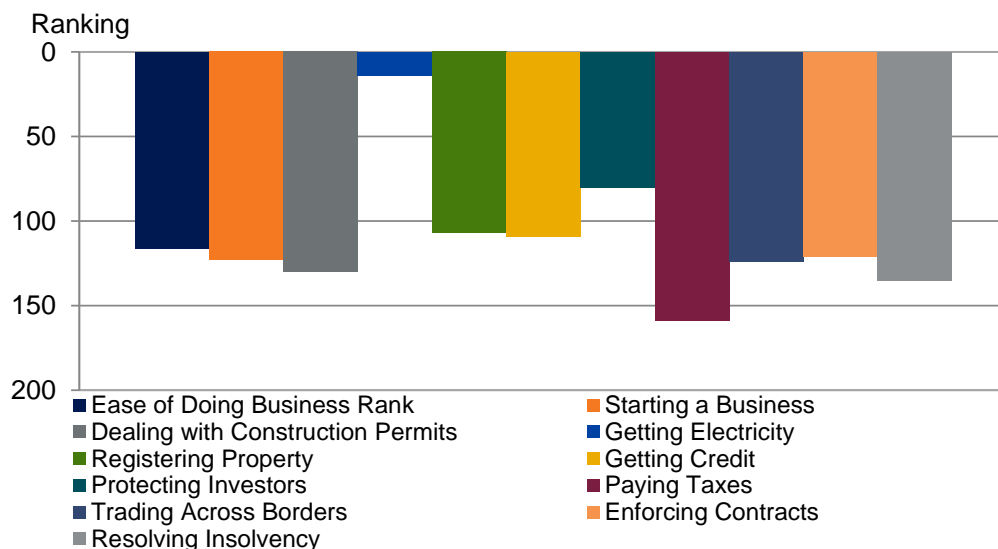
The fiscal situation in Brazil has been deteriorating over the last couple of years, with the deficit now at 3.4% of GDP. This gradual erosion has seen the sovereign's credit rating slip; Standard and Poor's cut Brazil's debt rating to just a notch above speculative grade in March. In the accompanying statement, S&P said the downgrade reflected *"fiscal slippage, the prospect that fiscal execution will remain weak amid subdued growth in the coming years"* and that credibility had been weakened by cuts to the main budget target and loans by state run banks (e.g. BNDES). Again, there appears to be little willingness on the part of Rousseff to address the problem - a few months after the downgrade the government injected another \$13.5 billion into BNDES and sharply increased social welfare payments in an attempt to boost both flagging growth and popularity.

Poor policies and intervention have reduced investment

Continued fiscal largesse from the government has also made the central bank's job more difficult too, though the inflation problem in Brazil has deeper roots than government fuelled demand. Despite one of the highest real interest rates in the world, Brazilian inflation persists at elevated levels, even as domestic demand decelerates. It is hard to see how this can be a demand problem, given that backdrop. Instead, inflation in Brazil is a result of chronic underinvestment, government intervention, and recently currency depreciation. The first two causes are interrelated; government controls on a range of prices, aimed at constraining inflation, have the opposite effect in the long run. Firms unable to hike prices or even project revenues have greatly diminished incentives to invest, resulting in scarcity and greater price pressure. Meanwhile, underinvestment in infrastructure drives up costs across a range of industries; a lack of port development sees such queues for loading and unloading that in 2013 some 25% of the soybean harvest was lost to spoilage.

This lack of investment is not a recent phenomenon. Infrastructure investment languished at around 2% of GDP in the 2000s, and the OECD estimates this would need to be increased to 4% to catch up with the rest of EM over the next 20 years. More generally, investment accounts for only 18% of GDP in Brazil, against 23% in Brazil's Latin peers like Chile, 30% in India, and 47% in China. As mentioned, this stems in part from government intervention on prices and other policy distortions. It also results from (and contributes to) the infamous "Brazil cost"; the increased operational cost of doing business in Brazil. The World Bank produces a series of indicators measuring the ease of doing business in a country, and in 2014 ranked Brazil 123rd (out of 189) for the ease of starting a business, 109th for getting credit, 130th for construction permits, and not much better on its other measures (chart 17). All of this contributes to the inflation problem and will require a concerted legislative push to tackle. The problem has shown little sign of improving under Rousseff, despite the repeated calls for action from investors.

Chart 17: Explaining the "Brazil cost"



Source: World Bank, Schroders. 29 September 2014

Overall it is hard to be positive on growth in Brazil

Unsurprisingly, this long list of negatives has resulted in an unappealing growth outlook for Brazil. Brazilian GDP contracted 0.9% year on year in the second quarter, or 0.6% in quarter on quarter terms. A look at the breakdown of GDP shows the weakness was concentrated in investment, which fell 19.6% year on year. Consumer spending, for now, continues to support growth, but with debt weighing ever more heavily it is unclear how long this can continue. Indeed, recent retail sales numbers suggest the consumer is flagging. Hopes for growth must instead rest on a change in sentiment among firms so that they can begin investing again. This will take a determined policy response to the assorted problems Brazil faces, as detailed above. That Rousseff has had years to address the issues and failed to do so despite repeated promises has undermined any belief that she is capable of real reform. A turnaround in Brazil then seems to rest on a change in government.

Policy solutions do exist to these problems...

Plotting a course out of troubled waters

When reading a list of the problems facing Brazil, even the cheeriest of optimists can become depressed. Even if a new government comes in, a silver bullet solution seems unlikely. Opposition candidates Aécio Neves and Marina Silva do at least seem to recognise the need for change, promising a more orthodox policy mix than the status quo. Despite her socialist background, Marina has mostly embraced the relatively right wing economics espoused by the late Eduardo Campos, and has selected respected economists as her advisers for the campaign.

On the current account problem, there is little that can be done immediately to help exports. But allowing FX weakness would restore some competitiveness, so an end to the current programme of central bank intervention in the currency markets would seem to be in order. Ultimately though Brazil's export problem is that it chiefly produces and exports commodities and it will take time to rebalance the economy towards manufacturing. This will require legislative changes to reduce the burden on businesses and enable them to compete globally, and other efforts to push down unit labour costs will also be needed. It may help to look at Spain as an example of how long this can take. Trade liberalisation is another policy option; Brazil has an average tariff rate of 10%, high even by EM standards. But again this is a long term play - removing protective measures should eventually see industry become competitive, but in the transition imports would likely increase before Brazilian industry adapted.

On the fiscal side, the simple answer would appear to be better fiscal policy. It has been argued that as the government is already running regular primary fiscal surpluses, there is not much scope for improvement here. But this overlooks the fact that the surpluses are reached increasingly through extraordinary measures, i.e. the surpluses we are seeing are not sustainable. Cuts will have to be made to BNDES subsidies and fiscal outlays more generally. The Brazilian tax burden is already high so it would appear the adjustment will largely have to come from the expenditure rather than revenue side. McKinsey estimates that government subsidies in Brazil amount to about 6% of GDP, so there is definitely fat that can be cut. However, it will be a difficult process politically and will drag on growth initially.

Investment would benefit from price liberalisation and a less interventionist stance from the government generally. While it is true that regulated prices for some products are still high by EM standards, this does not mean they are at "appropriate" levels - other EM economies do not have the same added operational costs Brazil has. Naturally, this will lead to increased inflation in the short run, with the payoff in terms of investment and lower inflation coming later. Meanwhile, monetary policy will have to stay tight to counter the renewed inflationary pressures, suppressing growth.

***...but there will be
no rapid
turnaround***

Overall, policy can make a difference but there will not be any immediate turnaround. Any new government will not take power until January of next year, and policy implementation will not be immediate. There is also a question of whether Silva could win a strong enough mandate; her Socialist Party is small in comparison to the Workers' Party of Dilma and Neves' Social Democrats, and coalition building would be needed. She should be able to get the Social Democrats onside - as a defector from the Workers' Party support there is less likely to be forthcoming. Then, as discussed, the benefits will take time to accrue. 2015 is likely to be another disappointing growth year for Brazil; we expect growth of 1.0%, compared to City consensus of 1.4%.

Schroder Economics Group: Views at a glance

Macro summary – September 2014

Key points

Baseline

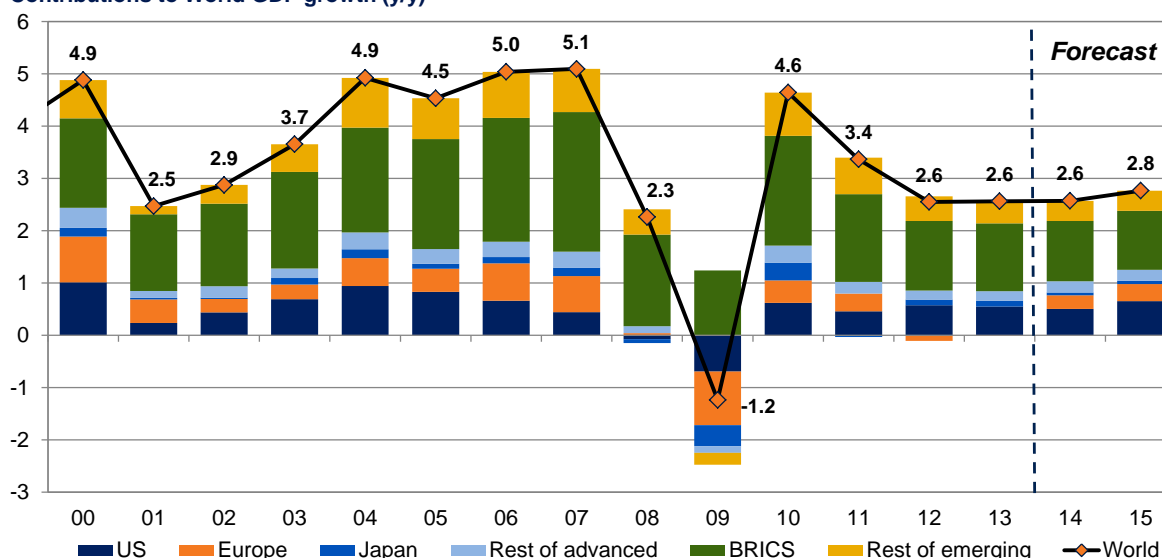
- World economy on track for modest recovery as monetary stimulus feeds through and fiscal headwinds fade in 2014. Inflation to remain well contained.
- US rebounded in Q2 after weather related dip in Q1. Unemployment to fall faster than Fed expects, wage and price growth to pick up as productivity remains sluggish. Fed to complete tapering of asset purchases by October 2014. First rate rise expected in June 2015 with rates rising 25 bps per meeting to 1.5% by year end.
- UK recovery to be sustained by robust housing and consumer demand whilst economic slack should limit the pick-up in inflation. Growth likely to moderate next year with general election and resumption of austerity. Interest rates to rise in February 2015 and reach 1.5% by year end.
- Eurozone recovery becomes more established as fiscal austerity and credit conditions ease in 2014. ECB on hold after cutting rates and taking measures to reduce the cost of credit, otherwise on hold through 2015. Deflation to be avoided, but strong possibility of QE (purchases of asset backed securities) in response to deflation fears.
- "Abenomics" achieving good results so far, but consumption tax has hit growth and Japan faces significant challenges to eliminate deflation and repair its fiscal position. Bank of Japan to step up asset purchases as growth and inflation fall back later in 2014.
- US leading Japan and Europe (excluding UK). De-synchronised cycle implies divergence in monetary policy with the Fed eventually tightening ahead of ECB and BoJ, resulting in a firmer USD.
- Tighter US monetary policy weighs on emerging economies. Region to benefit from advanced country cyclical upswing, but China growth downshifting as past tailwinds (strong external demand, weak USD and falling global rates) go into reverse and the authorities seek to deleverage the economy. Deflationary for world economy, especially commodity producers (e.g. Latin America).

Risks

- Risks are still skewed towards deflation, but are more balanced than in the past. Principal downside risks are Eurozone deflation and escalation of Russia-Ukraine crisis. Some danger of inflation if capacity proves tighter than expected, whilst upside growth risk is a return of animal spirits and a G7 boom (see page 21 for more details).

Chart: World GDP forecast

Contributions to World GDP growth (y/y)



Source: Thomson Datastream, Schroders 27 August 2014 forecast. Previous forecast from May 2014. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2013	2014	Prev.	Consensus	2015	Prev.	Consensus
World	100	2.6	2.6	↓ (2.8)	2.6	2.8	↓ (2.9)	3.1
Advanced*	63.0	1.3	1.6	↓ (1.9)	1.7	2.0	↓ (2.1)	2.3
US	24.8	2.2	2.0	↓ (2.6)	2.1	2.6	↓ (2.9)	3.1
Eurozone	18.8	-0.4	0.8	↓ (1.0)	0.9	1.2	↓ (1.4)	1.4
Germany	5.4	0.5	1.6	↓ (2.2)	1.7	2.0	↓ (2.3)	1.8
UK	3.7	1.7	3.0	↑ (2.9)	3.1	2.5	↑ (2.4)	2.6
Japan	7.2	1.5	0.8	↓ (1.2)	1.2	0.9	↓ (1.0)	1.3
Total Emerging**	37.0	4.7	4.2	(4.2)	4.2	4.1	↓ (4.3)	4.6
BRICs	22.8	5.7	5.1	(5.1)	5.1	4.9	↓ (5.1)	5.3
China	13.6	7.7	7.3	↑ (7.1)	7.4	6.8	(6.8)	7.1

Inflation CPI

y/y%	Wt (%)	2013	2014	Prev.	Consensus	2015	Prev.	Consensus
World	100	2.7	3.1	↑ (3.0)	3.2	3.3	↑ (3.1)	3.1
Advanced*	63.0	1.3	1.5	(1.5)	1.6	1.7	↑ (1.6)	1.7
US	24.8	1.5	1.7	↓ (1.8)	1.9	2.2	↑ (1.9)	2.0
Eurozone	18.8	1.3	0.7	↓ (0.9)	0.6	1.1	↓ (1.2)	1.1
Germany	5.4	1.6	1.1	↓ (1.3)	1.1	1.8	↓ (2.0)	1.7
UK	3.7	2.6	1.6	↓ (1.9)	1.7	2.2	(2.2)	1.9
Japan	7.2	0.4	2.7	↑ (2.0)	2.8	1.5	↓ (1.6)	1.8
Total Emerging**	37.0	4.9	5.9	↑ (5.7)	5.9	5.9	↑ (5.6)	5.6
BRICs	22.8	4.6	4.4	(4.4)	4.3	4.4	(4.4)	4.2
China	13.6	2.6	2.3	↓ (2.7)	2.4	3.0	↓ (3.1)	2.8

Interest rates

% (Month of Dec)	Current	2013	2014	Prev.	Market	2015	Prev.	Market
US	0.25	0.25	0.25	(0.25)	0.25	1.50	↑ (0.75)	0.91
UK	0.50	0.50	0.50	(0.50)	0.69	1.50	↑ (1.00)	1.46
Eurozone	0.15	0.25	0.15	↑ (0.10)	0.18	0.15	↑ (0.10)	0.20
Japan	0.10	0.10	0.10	(0.10)	0.19	0.10	(0.10)	0.19
China	6.00	6.00	6.00	(6.00)	-	6.00	(6.00)	-

Other monetary policy

(Over year or by Dec)	Current	2013	2014	Prev.	2015	Prev.
US QE (\$Bn)	4368	4033	4443	(4443)	4443	(4443)
UK QE (£Bn)	375	375	375	(375)	375	(375)
JP QE (¥Tn)	258	224	295	(295)	383	(383)
China RRR (%)	20.00	20.00	20.00	↑ 19.50	20.00	↑ 19.50

Key variables

FX	Current	2013	2014	Prev.	Y/Y(%)	2015	Prev.	Y/Y(%)
USD/GBP	1.67	1.61	1.68	(1.68)	4.3	1.63	(1.63)	-3.0
USD/EUR	1.34	1.34	1.32	↓ (1.35)	-1.5	1.27	↓ (1.30)	-3.8
JPY/USD	102.4	100.0	105.0	(105)	5.0	110.0	(110)	4.8
GBP/EUR	0.80	0.83	0.79	↓ (0.80)	-5.6	0.78	↓ (0.80)	-0.8
RMB/USD	6.15	6.10	6.12	↓ (6.18)	0.3	6.05	↓ (6.10)	-1.1
Commodities								
Brent Crude	102.0	109.0	107.1	↓ (108)	-1.7	105.5	↑ (104)	-1.5

Source: Schroders, Thomson Datastream, Consensus Economics, September 2014

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.

Market data as at 15/08/2014

Previous forecast refers to May 2014

* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, Switzerland, United Kingdom, United States.

** **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, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

I. 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

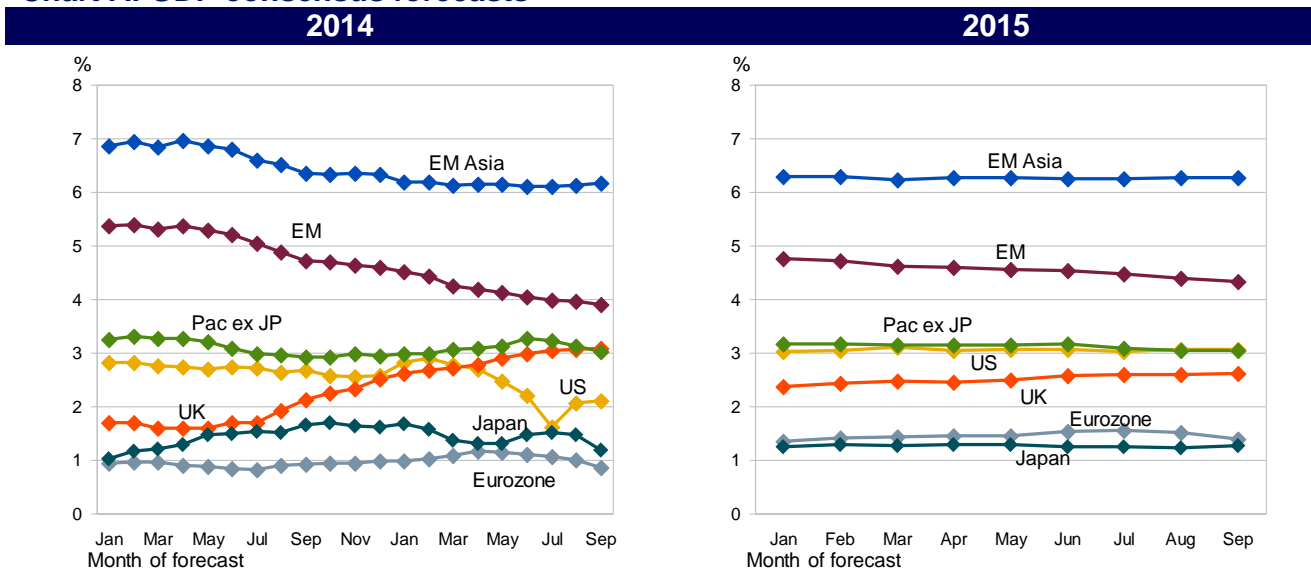
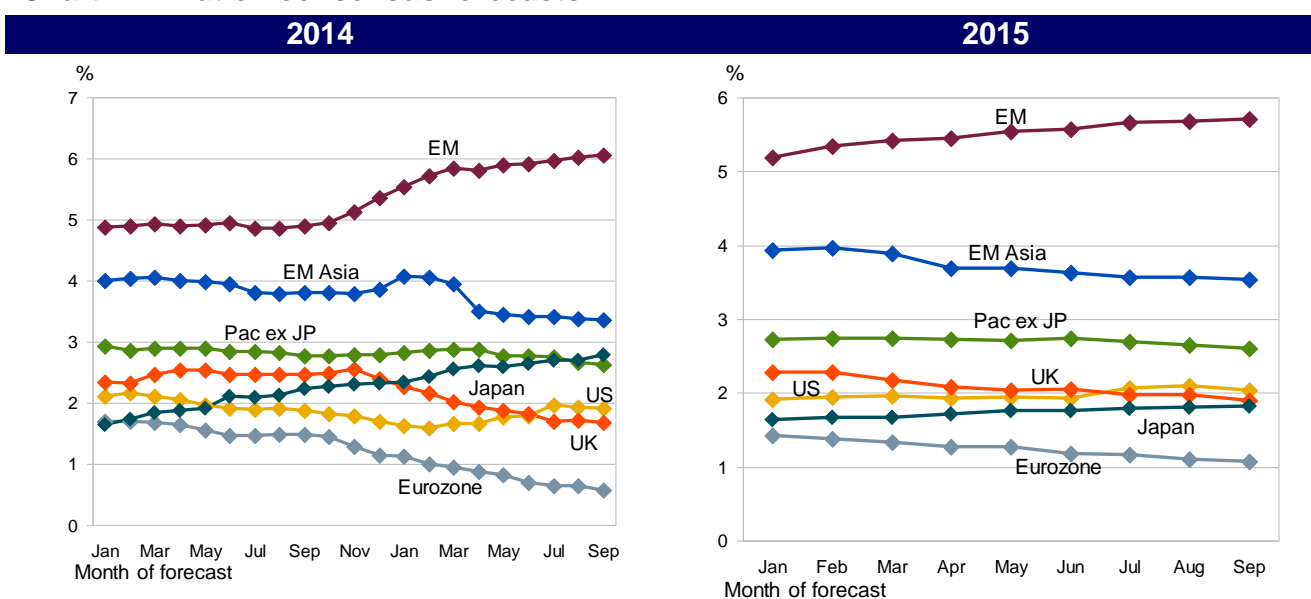


Chart B: Inflation consensus forecasts



Source: Consensus Economics (September 2014), 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, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. We accept no responsibility for any errors of fact or opinion and assume no obligation to provide you with any changes to our assumptions or forecasts. Forecasts and assumptions may be affected by external economic or other factors. The views and opinions contained herein are those of Schroder Investment Management's Economics team, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds. This document does not constitute an offer to sell or any solicitation of any offer to buy securities or any other instrument described in this document. The information and opinions contained in this document have been obtained from sources we consider to be reliable. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that Schroders has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. For your security, communications may be taped or monitored.