

# Schroders

## Economic and Strategy Viewpoint

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### Global: Are low interest rates a sign of secular stagnation? (page 2)

- Interest rates have fallen further with 21 central banks cutting policy rates this year whilst global liquidity continues to weigh on longer-term rates. However, despite six years of zero rates, global growth remains tepid and there are fears we are in a period of secular stagnation where the world will struggle with a chronic deficiency of demand. We have some sympathy for this view and recognise the risks, but ultimately see it as too pessimistic.
- The combination of a dovish outlook by the Federal Reserve and the strength of the dollar has caused us to push our first forecast for the rate rise out to September 2015 from June.

### UK: Political paralysis to slow austerity (page 6)

- The general election in May is set to be one of the most unpredictable elections in the UK's history as smaller parties capitalise on voters' disenchantment with the mainstream parties. Political paralysis may ensue, which is likely to disrupt the UK's progress in cutting its fiscal deficit. This is good news in the near-term, but over the medium-term will crowd out private investment, and may cause the already record current account deficit to expand further. Yet another reason to sell sterling.

### EM: Are exports emerging? (page 11)

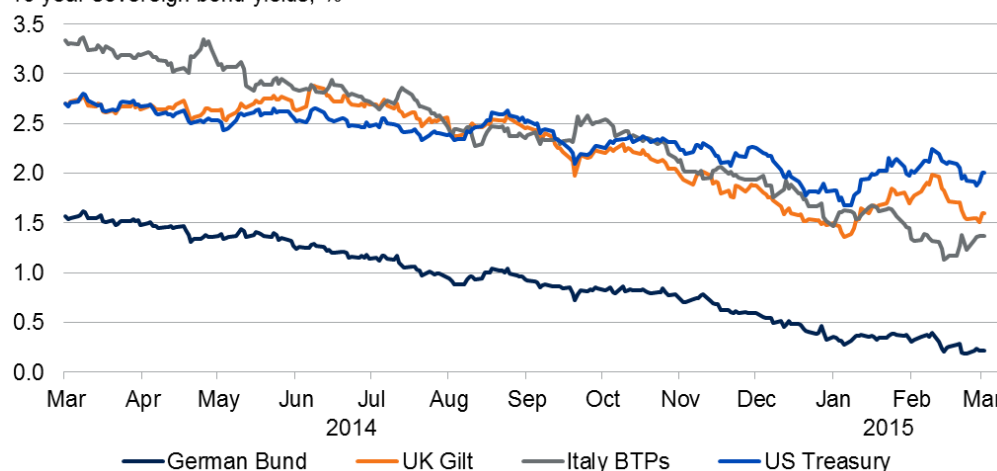
- A year of growth in the US and signs that the Eurozone may be turning the corner prompt a re-examination of export data in emerging markets. We could be in line for some isolated pockets of trade recovery this year.

### Views at a glance (page 15)

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

### Chart: Sovereign yields in retreat

10 year sovereign bond yields, %



Source: Thomson Datastream, Schroders. 26 March 2015.



# Schroders

## Global: Are low interest rates a sign of secular stagnation?

### Interest rates fall to new lows

Financial repression has intensified since the start of the year with interest rates falling significantly around the world. At the latest count, 21 central banks have cut policy interest rates in 2015 and long-dated yields have fallen to unprecedented levels in the Eurozone. At the time of writing the German yield curve is negative in bonds up to seven years in maturity and JPMorgan estimates that \$1.9 trillion (30%) of the euro area bond market is on a negative yield. The Eurozone has been the principal driver of the drop in G7 bond yields which are now below G7 core inflation for the first time in 20 years (chart 1).

**Chart 1: Sovereign bond yields drop below inflation in G7**



Source: Thomson Datastream, Schroders, 26 March 2015.

### ECB QE is playing a role, but are low yields symptomatic of a deeper malaise?

It is widely accepted that the driver has been the European Central Bank's (ECB) decision to start Quantitative Easing (QE) which has created a shortage of low risk assets in the region and put downward pressure on non-euro markets as investors have sought yield. We have already commented on these effects (most recently in the January Viewpoint) and attribute much of the recent fall in yields to QE, not just from the ECB but also the Bank of Japan (BoJ). Global liquidity continues to rise, even though the US Federal Reserve (Fed) brought its asset purchase programme to an end last year.

However, there is a concern that the latest fall in interest rates is just another chapter in a long running saga of declining yields and that the underlying trend is being driven by secular stagnation. This occurs when an economy suffers from a chronic deficiency of demand such that it requires lower and lower interest rates to stimulate activity. It is an idea that has been around for many years, but was recently resurrected by Larry Summers, the former US Treasury Secretary<sup>1</sup>.

The theory fits many of the facts as global growth has been disappointingly weak despite the fall in interest rates to record lows: some six years on since the recovery from the financial crisis began, it is remarkable that the Fed, Bank of England, ECB and BoJ all have interest rates at, or close to zero. Extraordinary policy stimulus has delivered less than ordinary results. Supporters of secular stagnation see the latest decline in rates as a continuation of a 30 year trend. If this is correct then any recovery will only be temporary and we will lapse back into weaker activity further down the road. Central banks will have to continue, or even restart QE and yields will trend even lower.

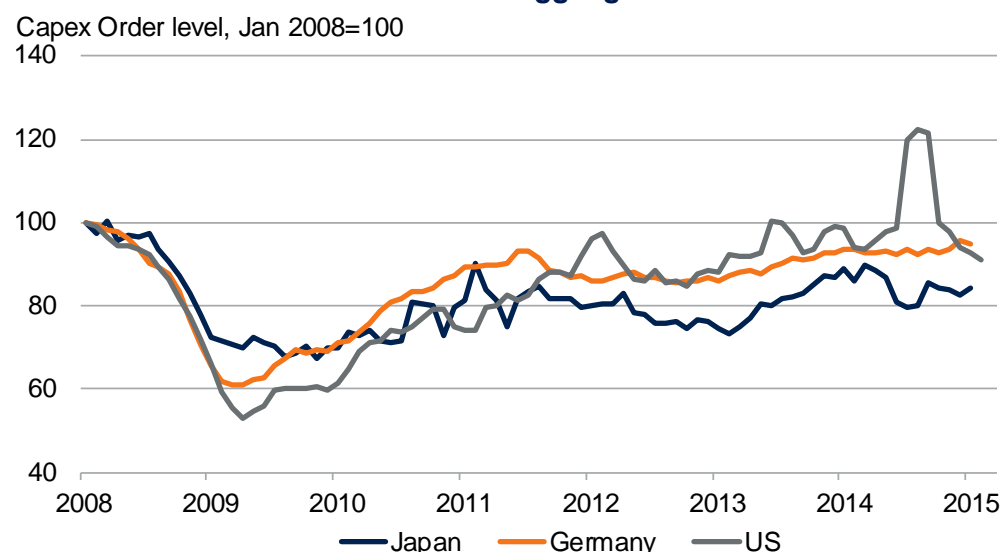
<sup>1</sup> For a recent example, see <http://larrysummers.com/wp-content/uploads/2014/06/NABE-speech-Lawrence-H.-Summers1.pdf>.

**Lack of investment ties in with the secular stagnation view**

Recent US data has tended to support the stagnation theory with the economy experiencing a torrid first quarter of 2015. After a series of disappointing data releases, current estimates suggest that the economy grew by a mere 1.5% (annualised) during the period.

One-off effects have played a role (another bad winter, West coast dock strike) but an area of persistent weakness, which ties in with the secular stagnation hypothesis, has been business investment. Orders for durable goods are struggling to get back to the levels reached prior to the financial crisis (chart 2). Lack of corporate investment is a sign that the cost of capital is still too high despite policy rates being close to zero. One of the tenets of secular stagnation is that future investment returns are seen as poor such that central banks cannot reduce the cost of capital sufficiently to compensate.

**Chart 2: Business investment still struggling**



Source: Thomson Datastream, Schroders, 26 March 2015.

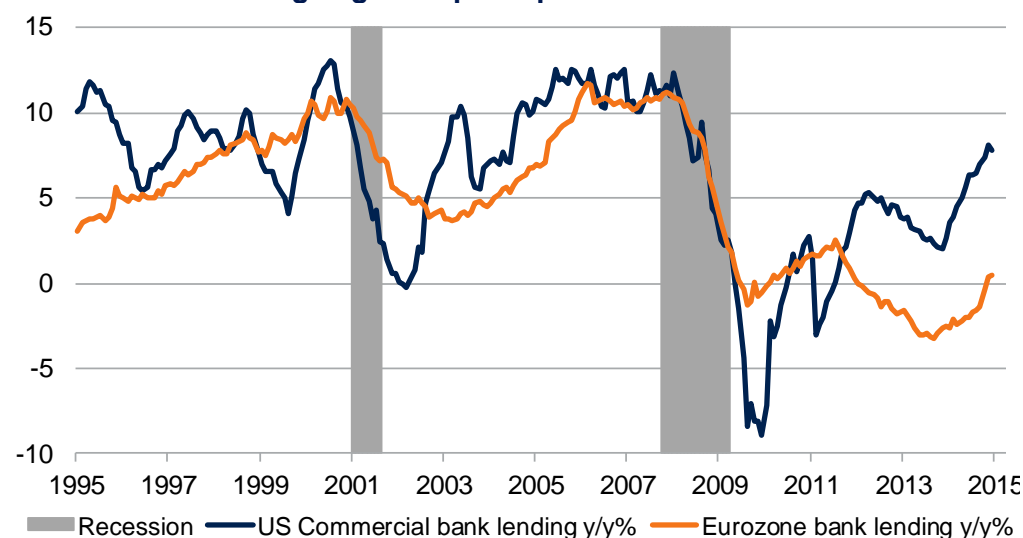
Whilst there is evidence for secular stagnation we would still see it as being too pessimistic. It was always the case that the shock to the banking system would take time to be overcome as the private sector went through a period of balance sheet repair. QE has helped speed that process by keeping interest rates low, thus easing the burden of debt, and driving up asset prices, so improving balance sheets.

The process is quite well advanced in the US and to some extent the UK, but is only just getting going in the Eurozone. Crucially, the US and UK recapitalised their banks at an early stage of the crisis, but the Eurozone has taken much longer. Last year's Asset Quality Review and stress tests brought this to a head and after a period of recapitalisation and retrenchment there are now signs that banks are beginning to lend again (chart 3 on next page). At the very least, this would remove a considerable headwind on Eurozone activity and should now provide support to the recovery.

From this perspective, we would see the world economy in a period of balance sheet adjustment with countries emerging at different rates from the banking crisis. Rather than a chronic lack of investment opportunities, the drag from balance sheet adjustment means that it takes more time for those opportunities to be realised. However, this process is not without its risks and we would identify four factors which will determine the path of the world economy.

However, balance sheet repair is progressing as Eurozone banks resume lending

**Chart 3: Bank lending begins to pick up in the Eurozone**



Source: Thomson Datastream, Schroders, 26 March 2015.

First, as the Eurozone has demonstrated, if the adjustment takes too long there is a danger that the economy can fall into deflation before recovery can take hold. There is then a risk of a debt-deflation spiral and, whilst we believe that the Eurozone can avoid this, it is critical that the region continues to see an improvement in growth and inflation in coming months to overcome the risk.

Is China next for balance sheet repair?

Second, we have seen the US, UK and the Eurozone are making the necessary adjustments, but there are others who probably need to follow the same path. In particular, China has run up significant debts to support the economy through the crisis. Although the government has a strong fiscal position and considerable control over the banks, we would not rule out another major recapitalisation of the financial system to purge bad debts.

Third, even when considerable progress has been made, bank caution persists. For example, although credit is growing in the US, it has not picked up significantly in the crucial housing sector. New regulation and the legacy of the crisis have injected considerable risk aversion into the sector such that even though mortgage rates are close to all time lows and house prices have been recovering, many find it hard to obtain a loan without a considerable deposit in the US and UK. This is holding back the housing recovery which continues, but with low volumes compared to the past.

Fourth, the opportunities exist, but will the private sector take them? It may be that government has to take a greater role in priming the private sector to invest again – a theme we will revisit in the future.

Overall, this suggests that the weakness of growth in the world economy is still a consequence of the crisis, as Reinhart and Rogoff made clear in their study<sup>2</sup>, recoveries from financial crises take considerably longer than those in a normal cycle. Consequently, we continue to forecast recovery in the developed world this year with the US picking up in the second quarter and growth in Europe and Japan improving. Admittedly though, at present it is difficult to distinguish this from a world suffering from secular stagnation, a factor that will weigh on long rates.

<sup>2</sup> This Time is Different: A Panoramic View of Eight Centuries of Financial Crises, NBER working paper March 2008.

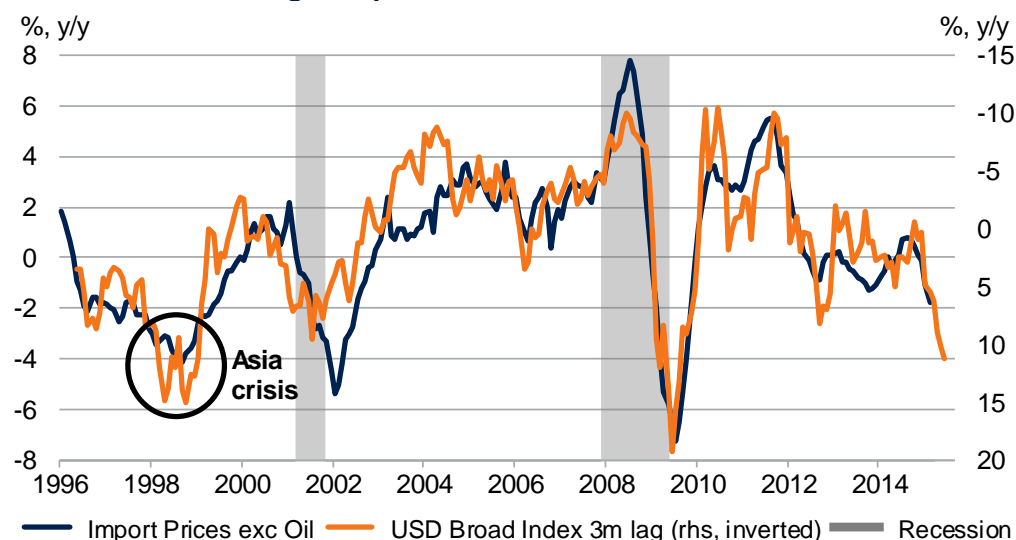
### Forecast update: pushing out Fed rate rise

Following the FOMC meeting which concluded on March 18<sup>th</sup>, we have pushed out our forecast for the first rate rise until September 2015. Although the committee changed its language and opened the door to a June move, it also cut its forecasts for growth, inflation and interest rates.

The factor which has swung the view has been the strength of the US dollar, which has exceeded even our bullish expectations. This may be one reason for the weakness of durable goods orders in the US as the currency hits profitability. More importantly from the Fed's perspective is that dollar strength is beginning to depress core inflation through lower import prices (chart 4). Although the Fed appears to be looking through the energy driven decline in headline CPI, it will take account of a lower core rate which is running at 1.7%, a tad below the 2% which it would prefer. Effectively the dollar has tightened financial conditions for the Fed (for more details see our recent Quickview: *Dollar strength tips Fed towards later rate rise*, 19 March 2015<sup>3</sup>).

Dollar strength is doing the Fed's job

Chart 4: Dollar strength depresses inflation



Source: Thomson Datastream, Schroders, 26 March 2015.

<sup>3</sup> <http://www.schroderstalkingpoint.com/tp/home/?id=a0j5000000BBoHNAA1>.

## UK: Political paralysis to slow austerity

Political risk is back in the UK. Having just recently avoided a breakup of the political and economic union, the UK is preparing to hold a general election as the fixed five-year parliamentary term comes to an end. The election on the 7th of May is set to be one of the most unpredictable in history as smaller parties take a greater share of votes. A range of outcomes are possible, but no clear favourite for investors. What is certain is that the result will not be clear cut, and may delay the UK's austerity plans.

### General Election 2015

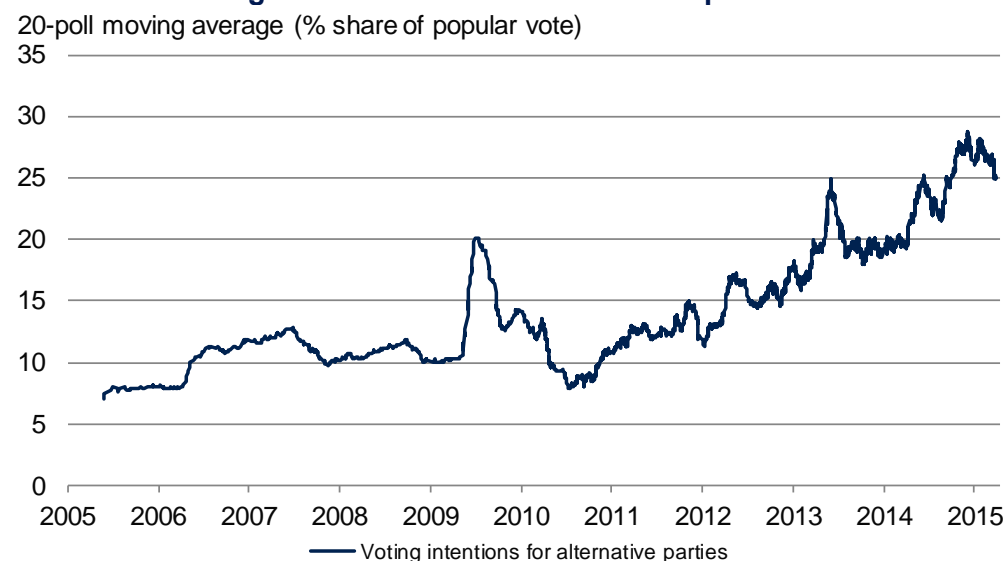
Political risk returns to the UK as the general election looms

Bankers and estate agents aside, politicians are still one of the most loathed professionals by the public. The parliamentary expenses scandal of 2009 remains fresh in the memory of voters, while the transition of the Liberal Democrat party to a governing party has pushed the anti-establishment vote elsewhere.

When excluding the three mainstream political parties from polling on voting intentions, the alternative parties now achieve more than double the share of intended votes compared to 2010 – rising from around 10% to 25% (chart 5). The Scottish National Party (SNP) has managed to maintain the momentum built after the referendum on Scottish Independence last year, and is now set to take most of the seats in Scotland. The UK Independence Party (UKIP) has also grown its support, reflecting growing disillusionment with the European project. UKIP did well in the European parliamentary elections last year, and more recently won its first two seats in parliament after two Conservative Party MPs defected. The Green Party has also picked up new support in recent months as it mixes green issues with anti-establishment rhetoric.

Small parties are capitalising on voters' disenchantment with the mainstream

### Chart 5: Voters signal discontent with mainstream parties\*



\*Voting intentions for all parties excluding the Conservative Party, the Labour Party and the Liberal Democrat party. Source: ukpollingreport.co.uk, Schroders. Last poll end date 26 March 2015.

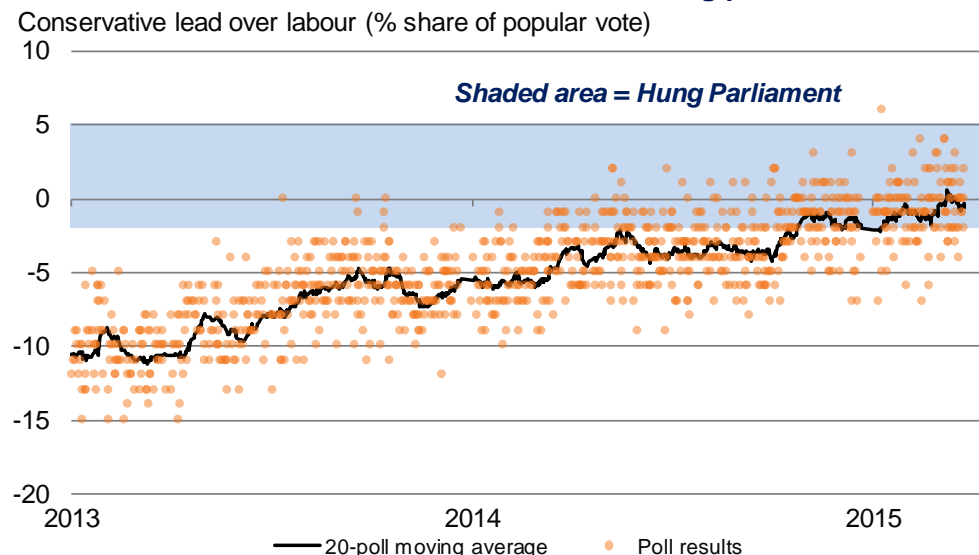
The rising popularity of the alternative parties makes it far less likely that a functioning government can be formed after the election. The UK's 'first past the post system' will, however, limit the influence of the newcomers. While, for example, UKIP is polling at around 15%, because its support is not concentrated in many areas, it is very unlikely to win say more than 10 seats (out of 650). On the other hand, the regional concentration of the SNP means that it is very likely to disrupt the political system and win most of the seats on offer in Scotland.

Turning to the three main political parties, the junior coalition partners the Liberal Democrats are likely to be severely punished this election for betraying a core part of their support. A key pre-election pledge by the party was to reduce or even eradicate university tuition fees, yet soon after joining the government, tuition fees were raised sharply. Despite leader Nick Clegg spending the best part of the last five years apologising for the lack of opposition to the change, the student population has not forgiven his party. The Liberal Democrats are currently polling at around 8%, a severe fall from grace when compared to the 23% of the popular votes achieve at the 2010 election. The Lib Dems will probably still outperform the likes of UKIP and the Greens thanks to strong grassroots support, and MPs campaigning on local issues. However, their role as kingmakers is all but over if they cannot hold most of their seats in the election.

As for the key battle between the coalition leaders the Conservative Party and main opposition the Labour Party, recent polls have them neck and neck. The Conservatives lost popularity over the parliament after implementing tough austerity measures, but they have been gaining ground as the economy has recovered. At this stage, the polls suggest that there is not enough of a difference for either party to win an outright majority (chart 6). Due to the oddities of electoral boundaries, Labour has a slight edge in terms of parliamentary seats based on national polls; however, that advantage has been reduced by the SNP success in Scotland.

Polls suggest that a hung parliament is the most likely outcome...

**Chart 6: General election set to return another hung parliament**



Source: ukpollingreport.co.uk, Schrodgers. Last poll end date 26 March 2015.

...but unlike the 2010 election, it will be harder to form a functioning coalition government.

The latest national polls suggest Labour will just about have the largest number of seats, but recent momentum is clearly with the incumbents, which is why betting markets (IG betting and Betfair) show that the Conservatives are favourites to retain power, or at least some sort of power. Regardless of which of the two wins the most seats, they will need the support of other parties. With the Lib Dems struggling, the main two will either have to work with other parties formally as part of a coalition, or serve as a minority government and negotiate support when trying to pass laws.

Labour has more options open to it given the left leaning tendencies of the SNP and Green party. The Conservatives have potential support from UKIP, possibly the Lib Dems again on some issues, and the Ulster Unionists (Northern Ireland). However, history suggests that minority governments usually fail before too long, and so we would emphasise the risk of a second election within about a year.

### Austerity is far from over

This month saw Chancellor George Osborne use his final Budget statement of this parliament essentially as a party political broadcast. Not only did he spend most of the speech highlighting the government's achievements over the past five years, but also signalled his party's intentions should it be returned to govern. The political use of the speech was so strong that it prompted the Liberal Democrat Chief Secretary to the Treasury Danny Alexander to unveil his alternative Budget highlighting the difference between the two coalition partners.

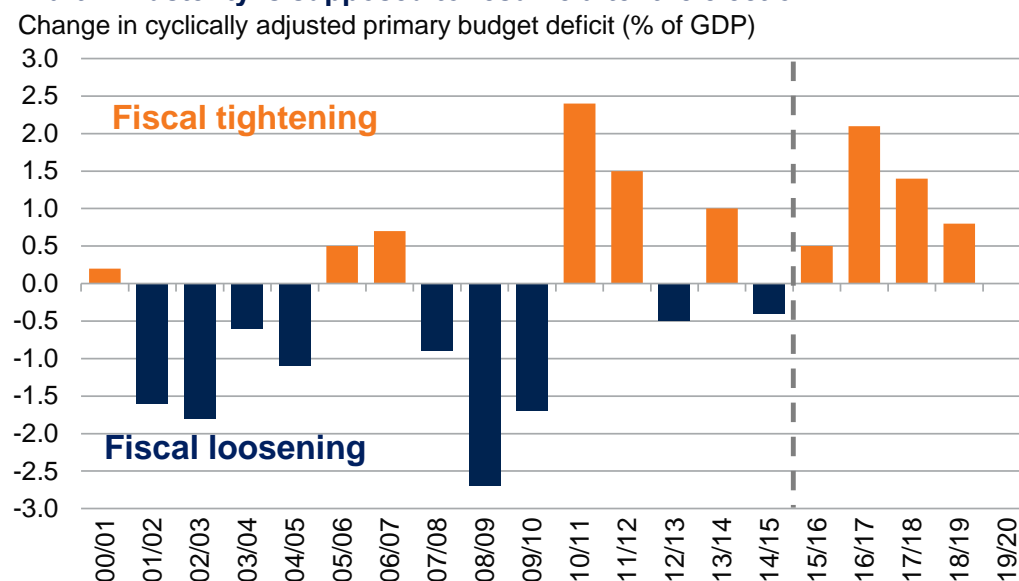
While the Chancellor's Budget this month was mainly political...

The Budget itself was light on policy changes, and where there were changes, they were used to kill off Labour party policy proposals. The independent Office for Budgetary Responsibility (OBR) was able to upgrade its growth forecast for the UK and downgrade its inflation forecast largely thanks to a further fall in global oil prices. The fiscal numbers looked marginally better too, although the Chancellor was still restricted in his fiscal manoeuvrability.

The key takeaway from the event for us was that austerity in the UK is far from over. Under the plans of the coalition government, cuts in public spending in fiscal years 2016/17 and 2017/18 would match the cuts seen over the previous six years (in terms of growth rates). Indeed, the OBR suggests that the government actually stimulated the economy this financial year. In fact, there has effectively been zero fiscal tightening since 2011/2012 – one of the main reasons for the improvement in economic activity. The OBR estimates that there will be some slight austerity in 2015/16, but that it will accelerate in 2016/17 to just over 2% of GDP and will continue at a slowing pace for a further two fiscal years (chart 7). For more detailed comments on the Budget, see Schrodgers Quickview: *Budget 2015 brings pre-election pause in austerity*, 19 March 2015<sup>4</sup>.

...it highlighted the need for ongoing austerity

**Chart 7: Austerity is supposed to resume after the election**



The change in the cyclically adjusted primary balance is the conventional way of measuring the fiscal impulse. The cyclically adjusted primary balance takes public sector net borrowing, strips out the part of the deficit caused by the economic cycle, and also removes interest payments. Source: Office for Budgetary Responsibility, Economic and Fiscal Outlook March 2015.

The UK is still running one of the largest structural deficits in Europe and needs to cut its deficit while the economy is performing well. If it cannot cut the deficit in a meaningful way, it risks not being able to cushion the economy when the next economic downturn arrives.

<sup>4</sup> <http://www.schroderstalkingpoint.com/tp/home/?id=a0j5000000BB0DcAAL>.



## Implications of political paralysis

Without a functioning effective government, not only does passing new laws become a problem, but also passing the all-important finance bill – the legal change needed to put the Budget into effect. Passing the bill is normally a formality for a government, but in a weaker government, this may become problematic.

All three of the main parties agree on one thing, that further austerity is required after the general election. However, they disagree on the scale, timing and mix of policy in terms of spending cuts and tax increases. Given the parties are looking to win votes at the moment, it comes as no surprise that they are not outlining exactly how they will achieve the difficult reduction in the budget deficit – which currently stands at around 5% of GDP.

**The two main parties agree on the need for austerity, but not the amount, timing or policy mix**

The Conservatives have pledged to eradicate the entire deficit by 2018/19, largely through departmental spending cuts, welfare spending reductions, and of course, the policy that keeps on giving: cracking down on tax evasion. Meanwhile, Labour wants to focus more on increasing taxes on wealthy individuals, but will also have to make some spending cuts, albeit less so than the Conservatives. They have not outlined the timing of cuts, but aim to balance only the current spending budget (excluding public investment). This harks back to old 'golden rule' which was used by former Prime Minister and Chancellor Gordon Brown of not borrowing other than to invest over an economic cycle. Of course, it did not stop Labour spending excessively during periods of strong economic growth. We estimate that the Conservative plan would mean about 5% of GDP worth of fiscal tightening, while Labour's policy would result in about 3.5% of GDP worth of tightening. The Lib Dems would go even slower, and also only target the current budget (about 2.7% of GDP).

The differences between the main two parties risk causing paralysis. Whichever party ends up governing, if it does not compromise on the mix of spending cuts versus tax increases, then it risks failing to pass the finance bill, and therefore quickly triggering another election.

**The impact of political uncertainty may temporarily hit business investment and employment...**

The macroeconomic implications are mixed. In the near-term, uncertainty is likely to lead to a pause in business investment, which may also cause a slowing in employment. Energy providers are concerned about a Labour government as they have pledged to cut home energy bills, while banks are also not looking forward to seeing the annual levy being increased further to fund public spending. Railway companies are concerned too after Labour muted re-nationalising the railways through state-sponsored corporations bidding for contracts when up for renewal.

Meanwhile, a variety of companies that trade with Europe are concerned about the prospects of a referendum on EU membership should the Conservatives win the election. Although Prime Minister David Cameron has said he will campaign to remain in the union if a deal over the UK's relationship can be struck, there is still a concern that much to the UK's ills will be blamed on its membership (such as EU migration being blamed for a lack of access to public services – which are being cut). The uncertainty is almost certainly already hitting foreign direct investment, where overseas investors in particular want to have access to the entire European market, not just the UK.

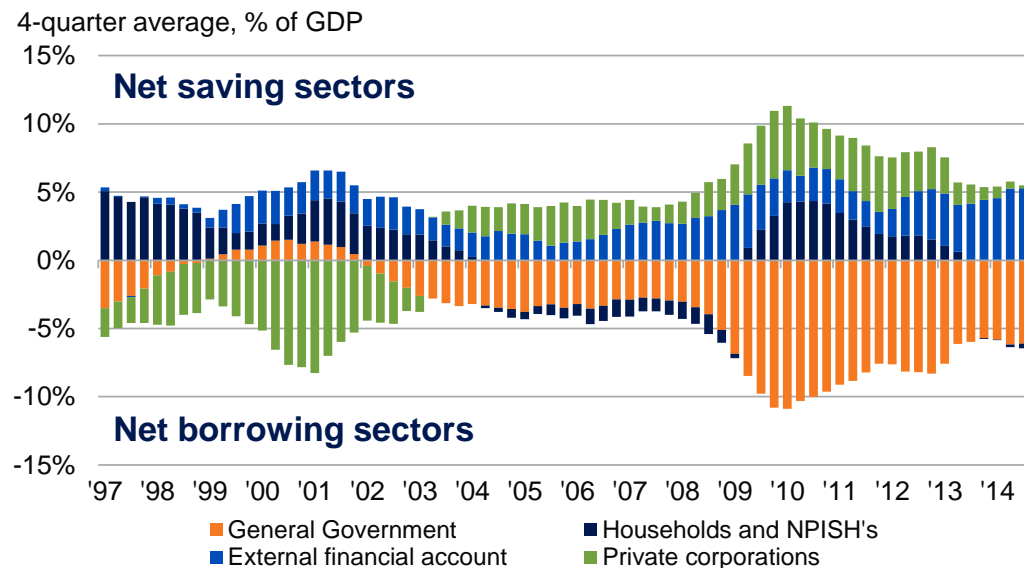
**...but a delay to austerity is better for growth than full-scale implementation...**

If the UK ends up with a coalition or minority government, then it becomes more likely that austerity becomes harder to implement. This could boost near-term economic growth compared to a scenario where tougher austerity measures are implemented. However over the medium-term, it will slow the reduction in the budget deficit thus leaving the UK vulnerable when global liquidity begins to tighten.

Chart 8 below shows that as the government was forced to expand its deficit from 2007 to 2010, the private corporate and household sectors ran a larger surplus, as they deleveraged. Note that aggregate borrowing has to equal aggregate saving in the economy at any point in time. When there is a deficit (borrowing/investment outpacing savings), it is met by borrowing from the rest of the world (external financial account), which results in a current account deficit. Since 2010, as the government has cut its deficit, it has allowed the corporate sector to save less, and for the household sector to just recently begin to borrow again.

...however over the medium-term, a large budget deficit will crowd out private investment, and may widen the current account deficit further...

**Chart 8: Government crowding out private investment**



Source: Office for National Statistics, Schroders. Updated 19 March 2015.

With the economy growing at a healthy pace, corporates are signalling that they would like to invest more, while households are also showing signs of confidence, usually associated with lower saving rates. However, with the government still borrowing large amounts, the deficit in aggregate savings is being met by the external financial account, which has now pushed the current account deficit to a record high of just over 5% of GDP. If the next government cannot significantly cut the budget deficit, then the only way the household and corporate sectors can expand investment growth rates further would be by a further expansion in the current account deficit. If the private sector cannot invest, then the economy's productive capacity will suffer, which reduces the UK's ability to grow without generating higher excessive inflation.

...which could prompt a further depreciation in GBP over time.

Historically, the crowding out of private investment would result in higher interest rates due to a lack of credit availability. However, due to the huge amounts of liquidity afforded by various QE programmes globally, interest rates remain very low. Nevertheless, a high current account deficit leaves the UK vulnerable to a sudden stop or even reversal in international capital flows. As a stable advanced economy, it should not suffer the problems some emerging market economies have done recently; however, if conditions were to tighten dramatically, then the UK could see a substantial depreciation in its exchange rate, as it did during the global financial crisis. This could cause inflation to rise which would push up UK interest rates. Against a backdrop of political uncertainty, a high current account deficit is just another excuse to sell sterling.

## EM: Are exports emerging?

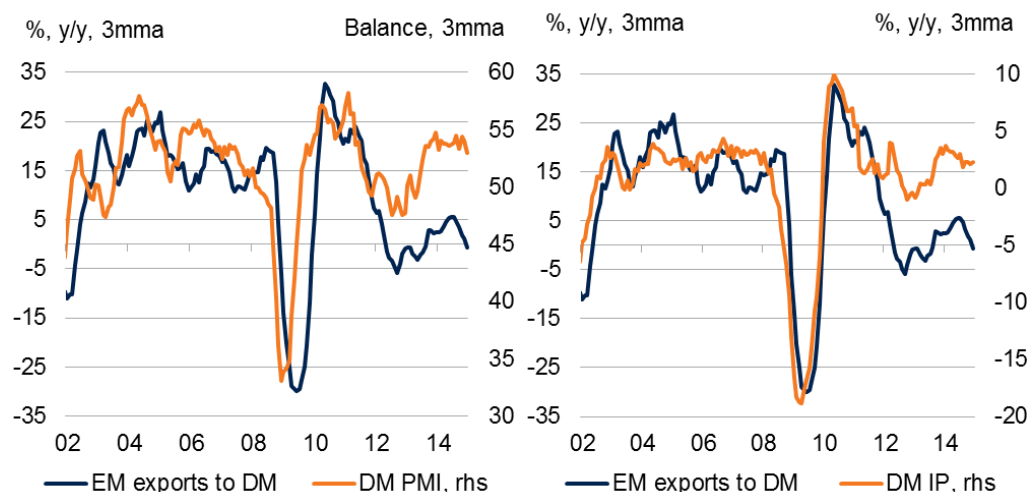
US growth should benefit EM exports...

In the middle of last year we wrote on the export recovery, or lack of one, in emerging markets (EM). Along with all other economic activity, global trade dropped off sharply during the Global Financial Crisis, which was a problem for export-reliant growth models across EM. As we noted last July, however, despite a recovery in growth in the developed markets, EM exports were failing to follow suit. Now, after a strong year of US growth, and with even Europe seeming to recover, we re-examine the data in the hope of finding some evidence that EM is benefitting from stronger growth in the developed world.

The first relationship to check is that between developed market (DM) activity and EM exports to those markets. Chart 9, below, shows how this relationship was altered by the crisis. Whether we look at soft data (PMIs) or hard data (industrial production), we should be seeing far higher growth in EM exports to DM than we do at present. Notable though is that DM demand and EM exports have not totally disconnected; after an apparent structural break in the relationship in 2012, EM exports have become strongly positively correlated with DM industrial activity once more. The difference is that industrial production (IP) growth of 3 – 4% in DM now generates export growth of around 3% in EM, compared to the 15 – 20% associated with that level in the pre-crisis era. With export growth looking essentially flat since 2012, is this an analogue of the secular stagnation thesis for EM exports?

...but the benefits seem greatly reduced

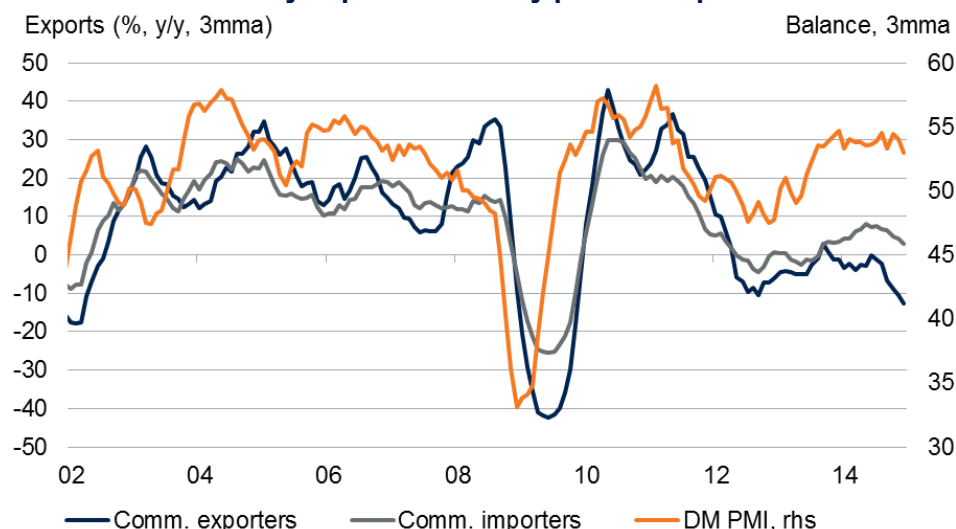
**Chart 9: EM exports benefitting less from DM growth**



DM PMI and IP are GDP weighted averages of those figures for the US, EU and Japan.  
Source: Thomson Datastream, IMF, Schroders. 25 March 2015.

Underpinning the idea of secular stagnation is a surfeit of savings and dearth of investment opportunities. We can certainly see parallels for EM; every country wants to export its way out of trouble but there seems little demand for the goods on offer. Nowhere is this truer than in commodities. Chart 10 shows that commodity exporters are in a much worse position – indeed, a worse one than we last reviewed the data. This largely reflects the recent sharp decline in commodity prices, led by oversupply of oil, and is negative for corporate earnings prospects in the affected economies. Commodity importers, meanwhile, have held up better, but the overall EM trend of export underperformance continues all the same.

**Chart 10: Commodity exporters hurt by price collapse**



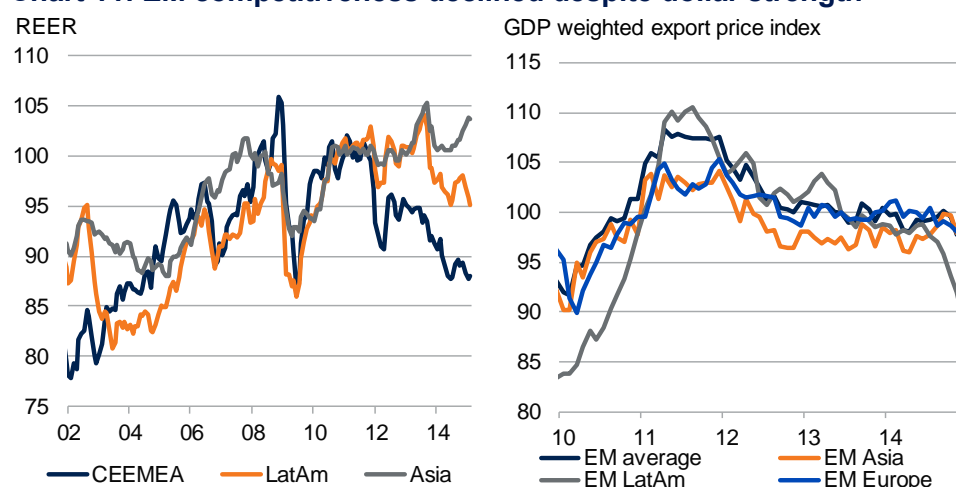
Commodity exporters: Brazil, Chile, Colombia, Indonesia, Malaysia, Mexico, Peru, Russia, South Africa. Commodity importers: China, Czech Republic, Hungary, India, South Korea, Philippines, Poland, Thailand, Turkey, Taiwan.

Source: Thomson Datastream, UN Comtrade, Schroders. 25 March 2015.

**Nominal depreciation has not seen effective depreciation**

Of course, one factor behind weaker commodities is a stronger dollar. But this also has a more positive corollary for EM, at least in terms of trade performance: currency depreciation. EM currencies have weakened markedly against the dollar since mid-2014, which should provide a boost to exports. Yet this does not seem to have happened. This is illustrated by the left hand panel of chart 11, below, which shows the real effective exchange rate for three EM regions. This is a better measure of competitiveness than the exchange rate versus the dollar as it takes into account relative price movements and the country's main trading partners. It is evident that unlike the 'Taper Tantrum' related currency weakness of mid-2013, the weakness since mid-2014 has not translated into improved competitiveness. In fact, in all three regions currencies actually became less competitive as the dollar strengthened, and in Asia this trend continues. This seemingly counterintuitive result can be explained by the even greater weakness (compared to EM currencies) of non-dollar DM currencies, particularly the euro, rendering Eurozone exporters more competitive than those in EM. This does not explain why EM exports are so much structurally weaker than previously, but does tell us why they have struggled despite currency depreciation.

**Chart 11: EM competitiveness declined despite dollar strength**



Export price sample consists of Brazil, China, Colombia, Czech Republic, Hungary, Indonesia, Malaysia, Mexico, Peru, South Korea, Poland, Thailand and Turkey. Source: Thomson Datastream, Schroders. 25 March 2015.

**EM export prices are falling, transmitting deflation**

Of course, the exchange rate is not the only way for EM producers to gain a competitive advantage. They may still be able to squeeze margins in favour of winning market share. The right hand panel of chart 11 looks at export prices in a range of EM economies. While Latin America is the stand out region for price falls (thanks chiefly to the region's commodities exposure), prices have also been falling in recent months for exports from Emerging Europe and Asia as well. It is impossible to know whether this is supply or demand driven, but either way this points to the pressures EM exporters are under, particularly when compared to the climbing prices from 2010 – 2012, before the DM-EM relationship broke down. This has implications both for EM corporates (lower earnings) and the global macroeconomic picture; EM economies are imparting a deflationary impulse via trade.

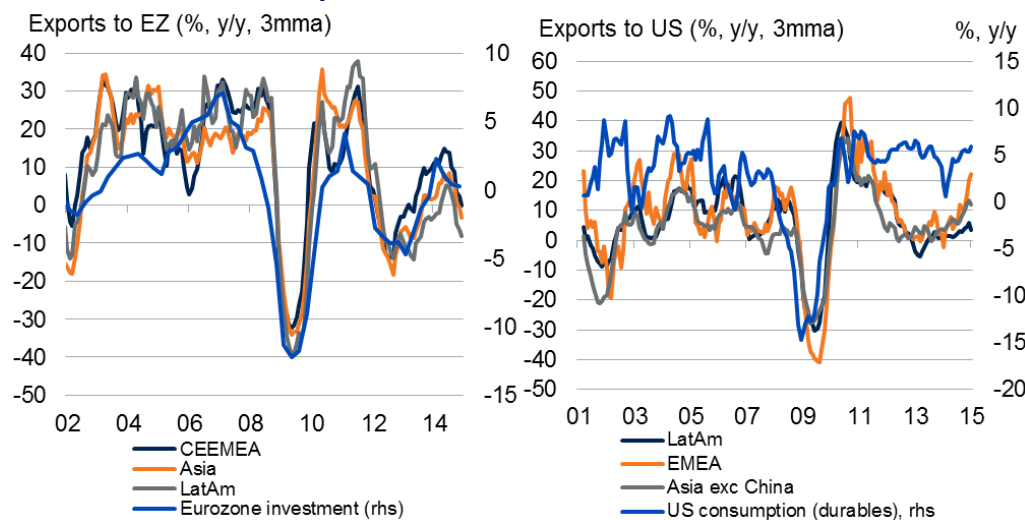
**Waiting for a catalyst**

Overall then, matters do not seem greatly improved compared to a year ago. What could turn this around? The major DM trade partners for EM are Europe and the US, with Japan accounting for a much smaller share of EM exports, so our analysis here will focus on those two economies.

**Exports to the US have actually been recovering...**

We have looked before at what drives imports from EM in the Eurozone and US, and found that while investment (measured by gross fixed capital formation) demonstrates a strong relationship for Eurozone imports, in the US it is the consumption of durable goods that seems more important (chart 12). One exception is Latin America, for whom investment dominates, which is unsurprising given the commodity-heavy nature of their exports.

**Chart 12: Drivers of import demand in DM**



Source: Thomson Datastream, Schroders. 26 March 2015.

**...and the signs are that exports to Europe could follow suit**

Chart 12 (above), shows that in fact exports to the US from Asia and EMEA climbed throughout 2014 as consumption of durable goods recovered, with only Latin America (LatAm) remaining flat. Meanwhile, exports to the Eurozone began to recover as investment picked up, before declining once more as it rolled over.

Importantly, this would suggest that there has not been a complete decoupling of DM activity and EM exports. As the US labour market continues to tighten, we would expect Asia and EMEA to benefit further, but Asia in particular given the US accounts for 14% of exports vs 3% for EMEA. Meanwhile, the link between Eurozone investment and EM exports remains strong, so any recovery there will be good news for EMEA (45% of exports) especially, and still helpful for Asia and LatAm (10% of exports). With a mild Eurozone revival forecast, and the US strengthening, Asian and European exporters could be about to benefit. Latin America, meanwhile, looks set to continue to struggle unless we see a lasting rebound in commodity prices. Given the rebalancing of China's economy and the

general overproduction problem throughout the commodity sphere, this is an unlikely prospect.

**Still hard to be  
positive on  
LatAm**

Summing up, export weakness appears to have a number of possible causes, but pinpointing the main culprit remains difficult. Commodity price weakness and the generally bearish outlook for that asset class presents a bleak future for metal and oil dependent Latin American economies, but an expected revival of Eurozone growth and continued US labour market strength should translate into gains for exporters of manufactured goods in Asia and Europe. At the moment, though, exporters under the cosh are being forced to cut prices, adding deflation to the global economy. The DM-EM relationship is weakened, but not broken.

# Schroder Economics Group: Views at a glance

## Macro summary – March 2015

### Key points

#### Baseline

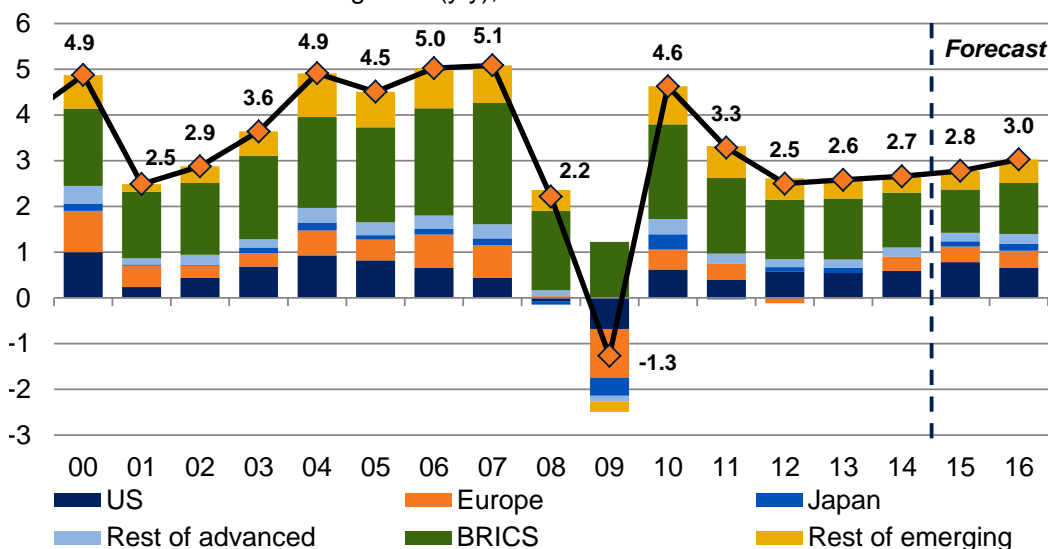
- Global recovery to continue at modest pace as the upswing in the advanced economies is offset by slower growth in the emerging markets. Lower energy prices will push inflation in the advanced economies to its lowest level since 2009.
- US economy on a self sustaining path with unemployment set to fall below the NAIKU in 2015, prompting Fed tightening. **First rate rise expected in September 2015 with rates rising to 1% by year end.** Policy rates to peak at 2.5% in 2016.
- UK recovery to moderate in 2015H2 with cooling housing market, political uncertainty and resumption of austerity. Interest rate normalisation to begin with first rate rise in November after the trough in CPI inflation. BoE to move cautiously with rates at 1.5% by end 2016 and peaking at around 2.5% in 2017.
- Eurozone recovery picks up as fiscal austerity and credit conditions ease whilst lower euro and energy prices support activity. Inflation to remain close to zero throughout 2015, but to turn positive again in 2016. ECB to keep rates on hold and continue sovereign QE through to September 2016.
- Japanese growth supported by weaker Yen, lower oil prices and absence of fiscal tightening in 2015. Momentum to be maintained in 2016 as labour market continues to tighten, but Abenomics faces considerable challenge over the medium term to balance recovery with fiscal consolidation.
- US still leading the cycle, but Japan and Europe begin to close the gap in 2015. Dollar to remain firm as the fed tightens, but to appreciate less than in recent months as ECB and BoJ policy is mostly priced in.
- Emerging economies benefit from advanced economy upswing, but tighter US monetary policy, a firm dollar and weak commodity prices weigh on growth. China growth downshifting as the property market cools and business capex is held back by overcapacity. Further easing from the PBoC to follow.

#### Risks

- Risks still skewed towards deflation on fears of Eurozone deflationary spiral, China hard landing and secular stagnation. Upside growth risks on a return of animal spirits and a G7 boom, fiscal stimulus in the Eurozone and lower energy prices. Stagflationary risks centre around a further deterioration in the Russia/ Ukraine crisis culminating in a cut off in energy supply to Western Europe.

#### Chart: World GDP forecast

Contributions to World GDP growth (y/y), %



Source: Thomson Datastream, Schrodgers 20 February 2014 forecast. Please note the forecast warning at the back of the document.

## Schroders Baseline Forecast

## Real GDP

y/y%	Wt (%)	2014	2015	Prev.	Consensus	2016	Prev.	Consensus
<b>World</b>	100	2.7	2.8	(2.8)	2.7	3.0	↑ (2.8)	3.1
<b>Advanced*</b>	63.2	1.7	2.2	↑ (2.0)	2.2	2.2	↑ (2.1)	2.3
<b>US</b>	24.5	2.4	3.2	↑ (2.8)	3.1	2.7	↑ (2.4)	2.9
<b>Eurozone</b>	19.2	1.1	1.3	↑ (0.9)	1.4	1.6	↑ (1.4)	1.7
<b>Germany</b>	5.4	1.6	1.6	↑ (1.2)	1.8	2.0	↑ (1.8)	1.9
<b>UK</b>	3.9	2.6	2.6	↑ (2.5)	2.7	2.0	↑ (1.8)	2.5
<b>Japan</b>	7.2	0.0	1.6	↑ (1.1)	1.1	2.2	(2.2)	1.7
<b>Total Emerging**</b>	36.8	4.2	3.7	↓ (4.1)	3.6	4.4	↑ (4.1)	4.5
<b>BRICs</b>	22.6	5.3	4.2	↓ (4.8)	4.2	4.9	↑ (4.7)	5.1
<b>China</b>	13.5	7.4	6.8	(6.8)	7.0	6.5	(6.5)	6.8

## Inflation CPI

y/y%	Wt (%)	2014	2015	Prev.	Consensus	2016	Prev.	Consensus
<b>World</b>	100	2.8	2.5	↓ (2.9)	2.4	3.0	↓ (3.2)	2.9
<b>Advanced*</b>	63.2	1.4	0.5	↓ (1.3)	0.3	1.8	(1.8)	1.7
<b>US</b>	24.5	1.6	0.7	↓ (1.5)	0.3	2.2	↓ (2.4)	2.3
<b>Eurozone</b>	19.2	0.4	0.1	↓ (0.8)	0.0	1.2	↑ (1.1)	1.1
<b>Germany</b>	5.4	0.8	0.4	↓ (1.4)	0.4	1.7	(1.7)	1.6
<b>UK</b>	3.9	1.5	0.6	↓ (1.3)	0.5	2.1	↑ (2.0)	1.8
<b>Japan</b>	7.2	2.7	0.6	↓ (1.3)	0.7	1.3	↓ (1.4)	1.2
<b>Total Emerging**</b>	36.8	5.1	5.9	↑ (5.6)	6.0	5.0	↓ (5.6)	5.0
<b>BRICs</b>	22.6	4.0	4.5	↑ (4.0)	4.5	3.6	↓ (4.0)	3.6
<b>China</b>	13.5	2.0	1.7	↓ (2.2)	1.5	2.0	↓ (2.7)	2.0

## Interest rates

% (Month of Dec)	Current	2014	2015	Prev.	Market	2016	Prev.	Market
<b>US</b>	0.25	0.25	1.25	(1.25)	0.67	2.50	(2.50)	1.44
<b>UK</b>	0.50	0.50	0.75	(0.75)	0.66	1.50	(1.50)	1.09
<b>Eurozone</b>	0.05	0.05	0.05	(0.05)	0.00	0.05	(0.05)	0.03
<b>Japan</b>	0.10	0.10	0.10	(0.10)	0.10	0.10	(0.10)	0.10
<b>China</b>	5.60	5.60	5.00	↓ (5.20)	-	4.50	↓ (5.00)	-

## Other monetary policy

(Over year or by Dec)	Current	2014	2015	Prev.	2016	Prev.
<b>US QE (\$Bn)</b>	4498	4498	4607	↑ (4594)	4662	↑ (4557)
<b>EZ QE (€Bn)</b>	0	0	600	-	1140	-
<b>UK QE (£Bn)</b>	375	375	375	(375)	375	(375)
<b>JP QE (¥Tn)</b>	300	295	383	(383)	400	↑ (383)
<b>China RRR (%)</b>	20.00	20.00	19.00	19.00	18.00	18.00

## Key variables

FX (Month of Dec)	Current	2014	2015	Prev.	Y/Y(%)	2016	Prev.	Y/Y(%)
<b>USD/GBP</b>	1.49	1.56	1.50	(1.50)	-5.9	1.48	(1.48)	-3.8
<b>USD/EUR</b>	1.09	1.21	1.12	↓ (1.18)	-12.2	1.09	↓ (1.14)	-7.4
<b>JPY/USD</b>	119.2	119.9	120.0	↓ (125)	14.1	125.0	↓ (130)	0.1
<b>GBP/EUR</b>	0.73	0.78	0.75	↓ (0.79)	-6.7	0.74	↓ (0.77)	-3.8
<b>RMB/USD</b>	6.22	6.20	6.30	↑ (6.20)	2.5	6.40	↑ (6.35)	1.5
<b>Commodities (over year)</b>								
<b>Brent Crude</b>	57.2	55.8	61.6	↓ (82)	-49.9	69.7	↓ (86)	10.3

Source: Schroders, Thomson Datastream, Consensus Economics, March 2015

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

Market data as at 27/03/2015

Previous forecast refers to November 2014

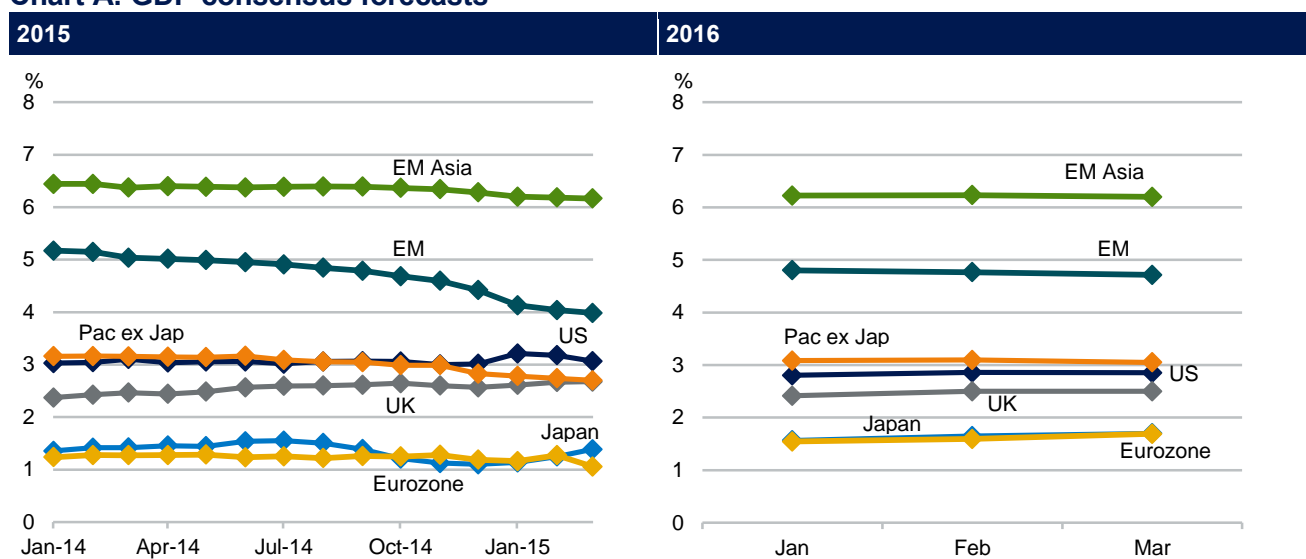
\* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.\*\* **Emerging markets:** Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.



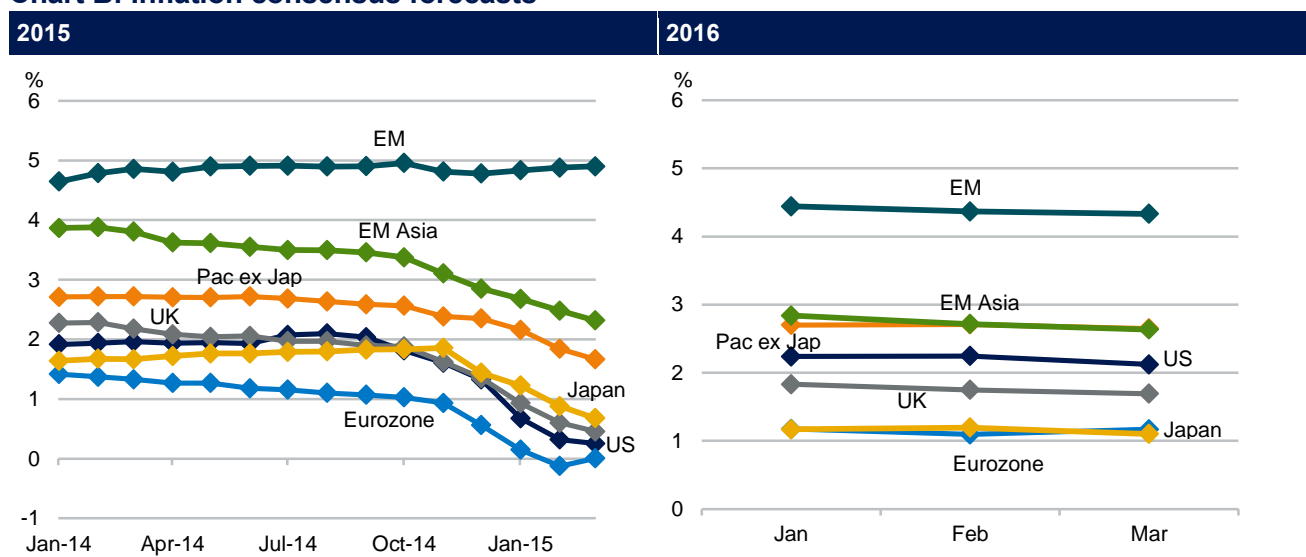
### Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

**Chart A: GDP consensus forecasts**



**Chart B: Inflation consensus forecasts**



Source: Consensus Economics (March 2015), 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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