



# Economic and Strategy Viewpoint

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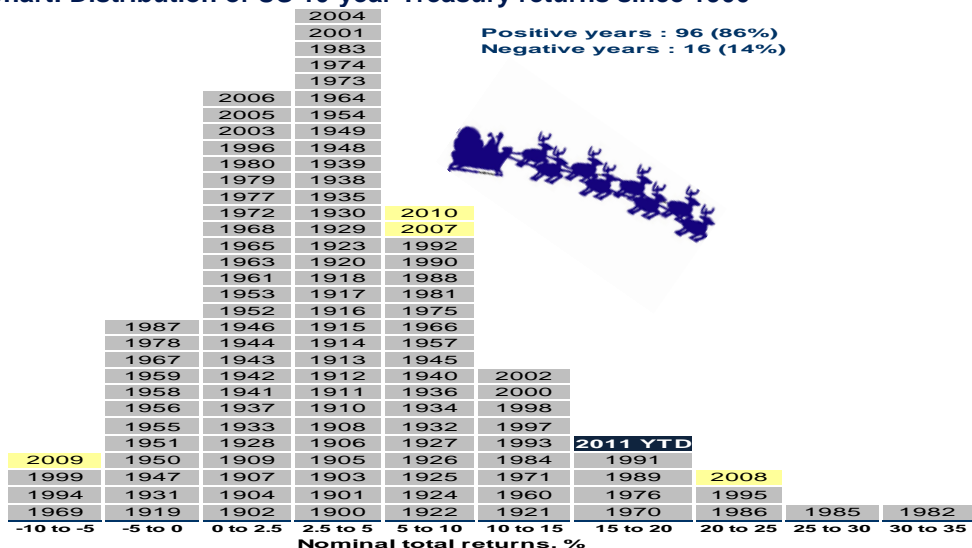
### Global: Themes for 2012

- Many will not be sorry to see the end of 2011, a year dominated by the crisis in the Eurozone and fiscal austerity and one where most equity markets lost money. Some though will remember 2011 with affection: US Treasuries, for example, look set to have recorded one of their best returns on record (see chart). Gilts have also done well, as has gold.
- It was not the year we expected twelve months ago as the recovery faltered and the world economy stalled. We were correct though on our call for a restructuring of Eurozone sovereign debt, the search for yield and the overheating problems in the emerging markets.
- We look for the cycle to take a more deflationary turn in 2012 as the Eurozone falls into recession, dragging on global activity. Such a backdrop will trigger more sovereign restructuring in the Eurozone and a continued search for yield as interest rates remain pinned to the floor. It will also be the year when politicians take to the stump: expect a burst of populism with wealth taxes and protectionism moving up the agenda.

### Markets: Risk off wins

- 2011 has been a disappointing year for risk assets all round. Buffeted by structural headwinds, major economies have struggled to build on the positive cyclical momentum from the end of 2010. The oil price shock, Earthquake and Tsunami in Japan, and more recently the Eurozone debt crisis, have all played their part in interrupting the recovery that was expected for this year.
- Government bonds have been the star performers in a year where central banks have done little in terms of interest rates, and where US Treasuries were downgraded! Unorthodox policy like quantitative easing, and operation twist have helped bring yields down further, though the worsening economic outlook has also pushed investors towards counter-cyclical assets.
- Looking ahead, it is hard to see much upside left to government bonds, especially with yields close to record lows, though if our view of a European credit crunch is correct, volatility in risks assets should remain. Investors may be reluctant to swap their government bonds, with risks assets, at least not until the ECB begins to hint at joining the quantitative easing party.

Chart: Distribution of US 10-year Treasury returns since 1900



Source: Global Financial Data, Thomson Datastream, Schroders, 21 December 2011  
Note: Cells highlighted in yellow shows the performance over the last 5 years.

# Global

## Global: Themes for 2012

Our key themes for 2012 are:

- for the macro cycle to turn more deflationary, with both growth and inflation expectations undershooting current expectations;
- more sovereign debt restructuring in the Eurozone; and
- for political risk to increase.
- Meanwhile, with no change in interest rates and more quantitative easing expected from the major central banks, the search for yield will remain as strong as ever.

Before looking at these in more detail we review our themes from 2011.

### Looking back

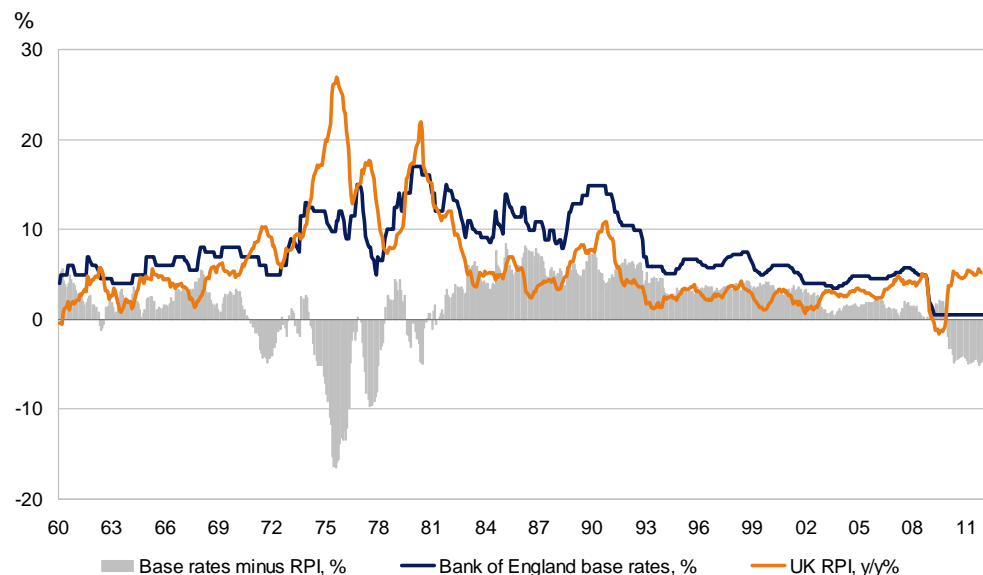
*Three of our four themes played out in 2011*

This time last year we identified four macro themes for 2011. First, the sweet spot in the global cycle was expected to continue, second, investors would continue to search for yield, third emerging markets would diverge from developed (but not in a good way) and fourth we would see a restructuring in Eurozone sovereign debt.

Clearly the first of these went astray and one of the lessons of 2011 has been the fragility of the cycle post the global financial crisis, however the other three have generally played out as expected.

The search for yield continued with investors under even greater pressure to move out of cash as high inflation cut into real returns (chart 1).

**Chart 1: Search for yield – negative real rates persist**

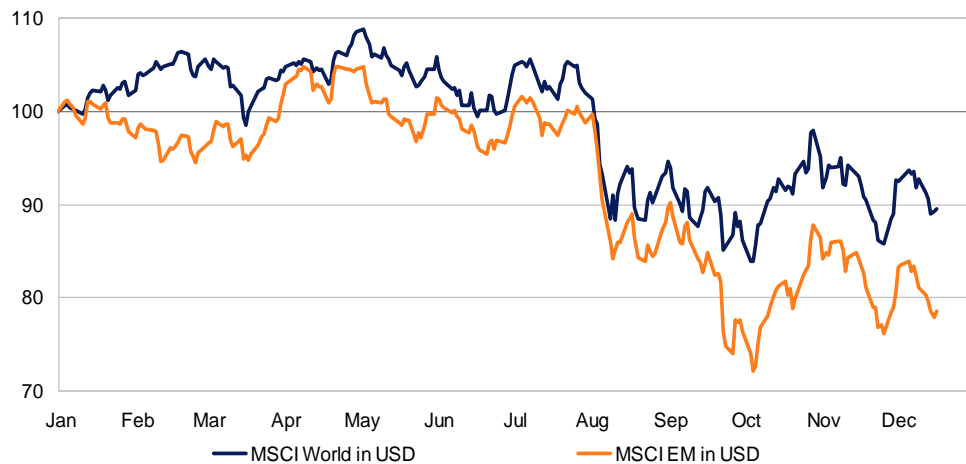


Source: Thomson Datastream, Schroders, 19 December 2011

Emerging markets underperformed as overheating and inflation fears dragged on performance (chart 2).

**Chart 2: Emerging underperform developed market equity**

Index (Base 100 = 31/12/2010)



Source: Thomson Datastream, 19 December 2011

Finally, at the Brussels summit at the end of October, EU leaders announced a 50% haircut on Greek debt held by the private sector. Whilst labelled “voluntary”, it represented a default in all but name. Although many now argue that such a move was inevitable, it was not seen that way a year ago as investors who bought protection (such as Greek CDS) will attest.

**Looking forward**

Two of these themes will remain relevant for 2012, the search for yield and Eurozone restructuring. Two themes are new. On the cyclical front we look for the return of deflation fears.

**1. From stagflation to deflation**

**Commodity price surge blew recovery off track, highlighting fragility of post crisis world economy**

One of the lessons of 2011 has been how fragile the world economy has become since the financial crisis. Our call for the world economy to be in a sweet spot in 2011 was blown off course by the sharp rise in commodity prices. We underestimated how the hit to real income would squeeze consumer spending, resulting in growth nearly stalling in the summer. When households are de-leveraging any hit to income tends to feed through almost one to one to spending. In other words, lack of access to credit and an unwillingness to borrow has removed a stabiliser for the household sector.

As a result we saw inflation expectations rise and growth expectations fall as we went through 2011 (see chart back page). So rather than a sweet spot of rising growth and falling inflation we had a stagflationary environment.

Going into 2012, our growth forecasts are below consensus indicating that expectations have further to fall, particularly in Europe. We detailed these in last month’s Viewpoint where we argued that developments in Europe pointed to a credit crunch and recession with knock on effects to the rest of the world.

On inflation, notwithstanding another spike in oil prices, we seem to have passed the peak with CPI rates falling around the world. When combined with weak activity and an output gap we would also look for inflation forecasts to come down as core pressures ease. Lower inflation will help growth, the reverse of this year’s headwind. The result though will be a move to a deflationary environment of falling growth and inflation expectations.

This view is reinforced by a tightening of fiscal policy which is slated to take effect next year. Using IMF data we estimate the fiscal impulse for 2012 to be just over minus 1% of GDP, a significant drag on growth and more than 2012 due to a swing in the US (see table 1). There is a risk that the impact on GDP also could be more significant as several countries are tightening at the same time. Consequently, spill over effects in terms of weaker trade growth might be greater than expected.

**Table 1: Austerity bites - fiscal policy tightens further in 2012**  
**Cyclically-adjusted primary budget deficits and fiscal impulse**

	% GDP			Fiscal impulse	
	2010	2011	2012	2011	2012
<b>Advanced economies</b>	<b>-3.8</b>	<b>-3.1</b>	<b>-2.0</b>	<b>-0.7</b>	<b>-1.1</b>
<b>US</b>	-5.1	-4.8	-3.4	0.3	-1.4
<b>Euro area</b>	-1.9	-0.5	0.6	-1.4	-1.1
<b>Japan</b>	-6.3	-6.7	-6.2	0.4	-0.5
<b>UK</b>	-5.6	-3.5	-1.9	-2.1	-1.6
<b>Emerging economies</b>	<b>-1.8</b>	<b>-0.9</b>	<b>-0.5</b>	<b>-0.9</b>	<b>-0.4</b>

*Key: cyclically adjusted primary deficit excludes the effects of the economic cycle and interest payments on borrowing, fiscal impulse is change in this deficit where – is a contraction, + fiscal expansion*

Source: IMF Fiscal Monitor September 2011, Schroder calculations

Consequently our cyclical theme for 2012 is the return of deflation fears. To the extent that this is driven by lower commodity prices, the fall in inflation can be seen as positive for the importing countries of the OECD where the terms of trade will improve. Emerging market consumers should also benefit as food and energy account for 30% of their average CPI basket.

However, the risks remain tilted in the deflationary direction. In addition to the threat of a break up of the Eurozone there is also an ongoing danger of a hard landing in China. The property bubble is finally bursting with prices beginning to fall. Whilst we are not forecasting a collapse in activity we would note that past experience of credit fuelled property booms tends to be that the impact on the economy is greater than expected.

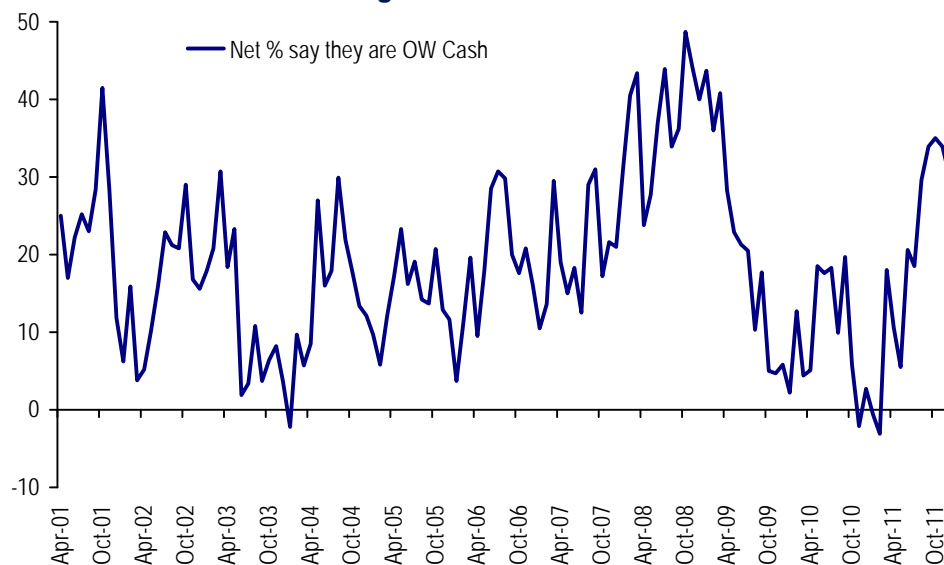
Against this backdrop global monetary policy is likely to ease further. For the major developed country central banks, where interest rates are at or close to their floor, this would mean more quantitative easing, in line with our call for the US, UK and European Central Bank (ECB) to be printing money in 2012. For the emerging country central banks it should mean cuts in interest rates and bank reserve ratios. China and Brazil are already moving in this direction. Notwithstanding the risk of a hard landing in China this could make for a better environment for the emerging equity markets in 2012, such that they reverse some of this year's underperformance.

## 2. The search for yield – an eternal quest?

### **Low interest rates to push investors into riskier assets as search for yield continues**

We expect no change in interest rates in the US, UK or Eurozone in 2012 and although inflation moderates, real interest rates are expected to remain in negative territory. The pressure to find yield will remain acute, pushing investors out along the risk curve.

Although this theme has been running for some time, risk aversion means that institutional investors remain overweight in cash, judging from industry surveys (see chart 3).

**Chart 3: Investors are overweight cash**

Source: BofA Merrill Lynch Global Fund Manager Survey, December 2011

At this point it is difficult to see when cash rates are likely to exceed inflation again in the US and Europe. The headwind of de-leveraging means that monetary policy is set to remain loose for a considerable period. The pressure to move out of cash will therefore remain strong.

The threat to this view would be that our deflationary environment ultimately results in outright falls in prices such that real interest rates turn positive. This has been the experience of Japan where investors continue to hold high cash balances as they can still earn a positive real return even with rates at zero.

### 3. Eurozone debt restructuring and financial repression

**Europe has taken a step nearer to fiscal union, but done little to address solvency problems**

The second continuing theme is Eurozone debt restructuring. The past month has brought another summit to save the Euro and whilst the headlines have focussed on the UK's veto and fears of isolation from Europe, the meeting did little to address the underlying solvency problems of the Euro region.

Europe has taken a step nearer to fiscal union with an agreement on fiscal rules to balance budgets, take action to keep public debt to GDP at 60% and apply automatic sanctions on those who err from the true path. Germany, with the support of France, seems determined to enforce Teutonic fiscal discipline on the periphery by legal means, the so called "Merkozy" plan.

However, anyone who has followed the travails of the Euro for the past 12 years must have a strong sense of déjà-vu given the resemblance these measures bear to the existing Stability and Growth pact. The failure of that pact to prevent the problems we face today does not seem to have fully registered in Berlin or Paris.

**Fiscal rules likely to be unenforceable**

Ultimately it has not been possible to make the rules work because no one was willing to impose financial sanctions on those who broke them. All members of the Euro are independent states and to impose fines or withdraw political representation would undermine their sovereignty, creating resentment and disengagement.

Disagreements meant no Treaty change was reached this time, but there is a commitment for the 17 members of the Eurozone to move ahead even if the rest will not follow. Not surprisingly though there was a noticeable lack of agreement on what the sanctions should be in the new pact, perhaps because most members know they are currently in breach of the rules and will struggle to meet them in the future. Some will also be thinking of Maastricht.

There were other measures to increase the resources of the bail out fund which should be welcomed. It is possible that a combination of bringing forward the creation of the ESM and central bank loans to the IMF might see Italy and Spain through, but it will be close.

***We still expect the ECB to implement QE next year***

In our view the weakness of the Euro area, with recession deepening into 2012, will force the Eurozone (primarily Germany) to accept a more aggressive ECB with the central bank implementing quantitative easing (QE) by next Spring.

Printing money is not a solution to the Euro area's problems, but it could buy time from the markets for the region to implement the changes necessary to create a sustainable fiscal union. This means transfers from surplus countries to those in deficit and Eurobonds, both of which have been firmly ruled out at present.

***But no grand bargain...yet***

Hopes for a grand bargain where the ECB responded to the summit by announcing it would become more aggressive have not materialised. However, the ECB did cut rates, extend liquidity auctions and loosen collateral requirements for banks at its meeting this month. The central bank is certainly fulfilling its requirement for financial stability by providing liquidity support to banks with the latest 3 year auction raising €489bn. Markets will be watching closely to see if the ECB also step up their bond buying operations (the SMP) beyond the current €20bn per week.

These moves are helpful, but the ratings agencies have warned that we can expect further downgrades of European banks. Such action, along with downgrades to sovereign countries, particularly the likely loss of the triple A rating in France, will no doubt trigger another crisis summit of EU leaders.

***ECB loosening is helpful, but still trying to crack a solvency problem with liquidity***

We would still see the ECB action as trying to meet a solvency problem with liquidity. As we have seen through the crisis this is unsustainable and in our view there will have to be write-offs and injections of capital before the problem is solved.

### **Enter financial repression?**

It is still possible that we get another straight restructuring of a peripheral countries debt. For example, Portugal and Ireland may ask why they have not had the same benefit as Greece in making such a move. Furthermore, our Euro break up scenario assumes restructuring on a major scale.

***Financial repression will look increasingly attractive to European governments***

Of course, our central view assumes that the ECB eventually resorts to QE and consequently it might be argued that we will not need to see more restructuring as the central bank hoovers up sovereign debt. This is possible, but we would still expect Germany to seek to limit QE to retain a semblance of fiscal discipline in the zone. Restructuring is needed to put countries on a sustainable footing.

Alternatively we may see a form of financial repression where investors are forced to hold government debt at low yields. For example, pension funds and insurance companies may be required to hold minimum levels of domestic government bonds in their portfolios, yields may be capped and cross border flows limited. This would be one way for governments to tame markets and speculators, who they blame for many of the problems in Europe.

In the past governments have used such regulation of their bond markets as a tool to obtain favourable funding. Recent research highlights how, when combined with inflation, financial repression had a powerful effect on reducing government debt in the late 1940s to the 1970s<sup>1</sup>. For Europe to follow this path we would need to see changes to limit the flow of capital and such a move may be some way off, but we would not rule out a further step in this direction in 2012 as governments seek to hold the single currency together. The first step has already been taken with the decision to make the private sector holders of Greek debt accept a “voluntary” haircut on their assets. Official investors were unaffected.

#### 4. Political risk to increase

### *2012 will bring a glut of elections*

The prospect of governments tightening regulations on investors through financial repression returns us to politics. 2012 is set to see a concentration of elections with Presidential contests in the US, France and Russia plus a number of important Parliamentary elections. South Korea has both, there is a transition in China and Syria is due to hold elections in February (see table 2).

**Table 2: 2012 election timetable**

Date	Nation	Election
14 <sup>th</sup> January	Taiwan	Presidential & Legislative
22 <sup>nd</sup> January	Finland	Presidential (First Round)
February	Syria	Legislative
February	Greece	Parliamentary
4 <sup>th</sup> March	Russia	Presidential
29 <sup>th</sup> March	Iran	Parliamentary
22 <sup>nd</sup> April	France	Presidential (First Round)
April	South Korea	Parliamentary
1 <sup>st</sup> July	Mexico	Presidential & Legislative
July	India	Presidential
Autumn	China	Leadership Transition
6 <sup>th</sup> November	United States	Presidential & Legislative
December	South Korea	Presidential

Source: IFES Election Guide

### *Investors are more dependent on governments as a result of the crisis*

The financial crisis has increased political risk in the markets. First, investors became dependent on governments to rescue the banking sector, a process which is not over yet in Europe. Then, as it became apparent that central banks no longer had the power to drive growth, investors looked to governments to take the initiative. At the same time the weakness of economic activity has undermined many administrations and led to a wholesale change of leadership, particularly across Europe.

In 2011 politics led to some spectacular brinkmanship with 11<sup>th</sup> hour deals to lift the debt ceiling in the US and agree bailouts in Europe. No doubt we will see more of this in 2012, but with politicians returning to the campaign trail we can expect politics to have a different effect. The weakness of growth and difficult outlook means that the political debate will increasingly become one of how to divide up the economic pie. So far this has generally meant targeting bankers, and Occupy Wall St has struck a chord with the public.

<sup>1</sup> The Liquidation of government debt by Carmen Reinhart and M.Belen Sbrancia, NBER working paper, March 2011

***Expect more  
argument over  
how to divide the  
pie***

However, the battle ground is likely to open up. As mentioned above, institutional investors may be coerced into being more supportive of their governments. The non-financial sector is also vulnerable. For example, the cash rich corporate sector could become a target for governments looking to plug borrowing gaps. Taxes paid by the US corporate sector are at a low as a share of GDP, for example.

***Protectionism to  
increase***

As the global economy slows, international tensions are likely to escalate. Protectionism is moving back onto the agenda as politicians seek to shift the blame for domestic economic malaise to overseas. There are already signs of tension between China and the US over cars, this could well extend into other areas. The foreign exchange markets are likely to be the area where these tensions are made manifest.

***And tensions  
remain in the  
Middle East***

Finally, the Arab spring, which caught many commentators by surprise, is not over yet. Egypt is still struggling toward democracy, but the real focus is now on Syria where there is a risk of more turmoil or involvement by neighbouring countries. As a result we could still see another damaging spike in the oil price, particularly if Saudi Arabia or Iran became entangled.



# Markets

**2011 was a disappointing year for risk assets as major economies were battered by shock after shock.**

## Markets: Risk off wins

At this time of year, we like to take a step back and review the performance of markets, and the lessons we can learn for the coming year. 2011 was a disappointing year for many investors, and for risk assets overall. The year began with cautious optimism, with the global economy benefiting from the tail-winds of the inventory cycle rebound, with some leading indicators hitting multi-year highs.

Investors were aware that some of the structural problems that the 2008/09 credit crunch had revealed were still unresolved. As the year progressed, the global economy was battered by shock after shock.

Tensions and eventual revolutions in the Middle East and North Africa region led to a sharp rise in oil prices in the spring, which consequently sapped the disposable income of households in the West. In addition, the tragic earthquake and tsunami in Japan may not have affected global export demand, but it certainly disrupted production supply chains. Meanwhile, the Greek debt crisis eventually evolved into a full peripheral debt crisis, and in our view, is evolving into a credit crunch - though the latter will be proven either way next year.

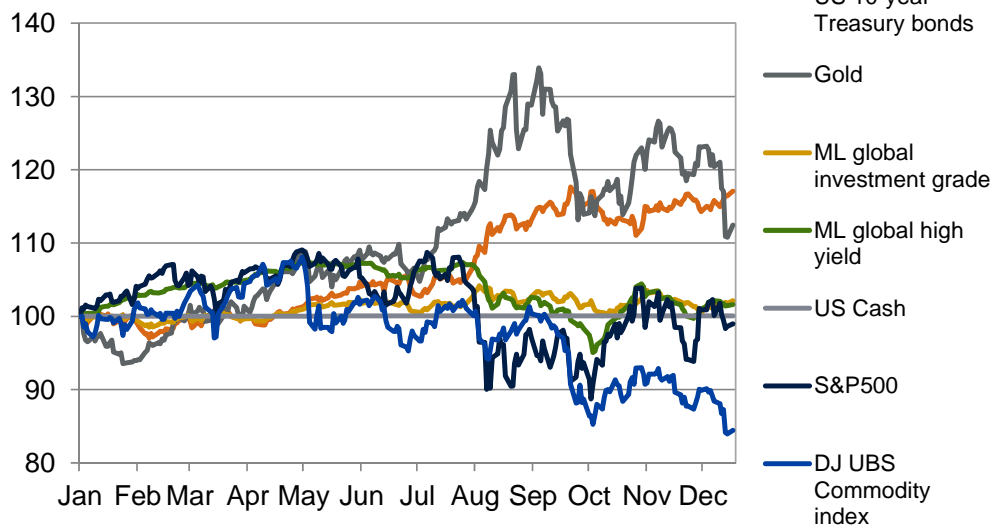
## Cross-asset comparison

Looking across the major asset categories, government bonds have been the clear winners of the year. Though US Treasuries were underperforming all of the other assets in our simple universe at the start of the year, as the event risk began to escalate during the Spring, Treasuries began climbing back up the leader board (see chart 4 below). As we approach the end of the year, 10-year Treasuries are set to return about 16% for the year, which would be the 5<sup>th</sup> best annual return since 1900 (see chart on front page). That has come during a year when the US government almost shut down as the administration risked reaching the US debt ceiling, and we had a downgrade by rating agency S&P from AAA.

**Between the major asset classes, government bonds were the clear winners, despite the debt ceiling debate in the US, and the downgrade by S&P.**

**Chart 4: Comparing market returns**

100=31/12/2010



Source: Thompson Datastream, Schroders. Updated 20 December 2011. All returns are calculated on a total returns basis.

***The Arab Spring helped boost energy prices, though as tension subsided, commodities generally slid back.***

The Arab Spring led to a spike up in energy prices, which helped the Dow Jones UBS commodity index to perform well until the end of April, but early signs of resolution to the Arab Spring, and better than expected oil supplies caused prices to fall back. Moreover, weaker than expected GDP data from the US and Europe, and with China tightening monetary policy, analysts began to downgrade demand expectations for many commodities. Industrial metals were one of the hardest hit (-23%), though softer commodities like cotton and wheat have also ended the year sharply down (-38% and -24% respectively).<sup>2</sup>

Meanwhile, equities have had a tumultuous year. Though corporate earnings have performed relatively well, market sentiment has been poor, not helped by the high degree of macro uncertainty, which investors hate. The S&P500 was up 7% by the end of the first half, before suffering a 16% fall over the summer, mainly during the period of the debt ceiling debate and the escalation of the Eurozone debt crisis, but also interesting to note, the falls occurred as the second round of quantitative easing was coming to an end in the US.

By the Autumn, markets were trading like they were in 2008/09. Very little liquidity, with attention focused on political developments. As concerns about growth increased, fears of higher inflation looking ahead began to fade as annual rates appeared to peak. This appears to have coincided with gold falling back from poll position as the precious metal began to lose its shine. Having hit multiple new record highs this year (\$1,900/oz last peak), gold has been trading more like a risk asset, with a strong positive correlation with equities and a negative correlation with the USD.

### **Regional equities comparison**

Returns on the S&P500 should end the year fairly flat once dividends are taken into account, though the premiere US index does not reflect the fortunes of equities elsewhere in the world. European bourses have had a terrible year, which comes as no surprise given recent events in the region.

The worst of the large markets has been the Italian FTSE MIB, with a dismal -20% return year to date (chart 5). However, that is closely followed by the high beta (or cyclical) MSCI Emerging Markets index, and the French CAC40. Interestingly, the Spanish IBEX35 managed to outperform the German DAX30 index in the end, though that is partly thanks to the more defensive nature of the Spanish index.<sup>3</sup> Indeed, in addition to the S&P500, it was the UK FTSE100 with its more defensive composition of stocks that beat the MSCI World index.

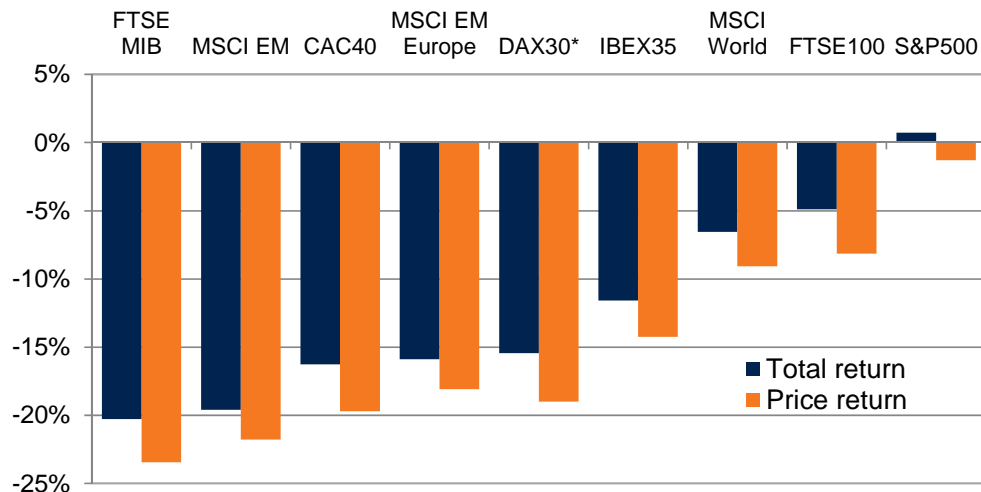
<sup>2</sup> Goldman Sachs Industrial Metals Commodities index used to calculate industrial metals returns. Cotton and wheat returns calculated using active future contracts. All returns calculated as year to date returns to the end of 20 December 2011.

<sup>3</sup> 45% of constituents of the IBEX35 are in the energy, utilities, healthcare and telecoms sectors, compared to only 26% of the DAX35 index. Source: Bloomberg.

**Equities had a tumultuous year, though the flat performance masks large losses from indices in other parts of the world.**

**Chart 5: Select equity indices' performance**

Returns since 31/12/2010



\*DAX30 index is a total returns index. Therefore, the price return is estimated by subtracting the average dividend yield for the year to date from the total return calculation.  
Source: Thompson Datastream, Schroders. Updated 20 December 2011.

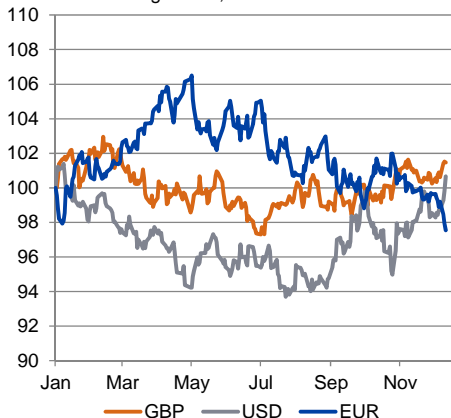
**Currencies**

**Despite the large swings in risk assets, currencies were remarkably stable...**

Given the large gyrations in the performance of risk assets this year, we would have expected greater volatility in currency markets. However, the lack of movement between key pairings has been remarkable. Using the Bank of England's trade weighted indices, chart 6 (below) shows how the USD will end the year with a slight appreciation, EUR should see about a 2% depreciation, while GBP has seen the most appreciation of the three despite poor economic growth, much higher inflation, and a central bank that is printing money like its going out of fashion!

**Charts 6 & 7: Major global currencies performance**

Effective exchange rates, 100=04/01/2011



Effective exchange rates, 100=04/01/2011



Source: Bank of England, Schroders. Updated 20 December 2011.

Meanwhile, even the exporting currencies have seen mixed performance. The AUD and CAD moved in lockstep, appreciating in the first half, but falling back in the second - reflecting commodity price movements.

**...with the exception of the JPY and CHF, both requiring central bank interventions to halt sharp appreciations.**

The JPY was depreciating at the start of the year as risk assets performed well (and some central banks raised interest rates). However, the Japanese earthquake and tsunami marked the start of a continued appreciation of the Yen for the rest of the year. Investors went back into the historically defensive currency as they expected the Yen to be well supported by inward capital flows from the pay out of insurance policies in response to the natural disasters. Despite a number of attempts by the Bank of Japan to push the Yen lower, intervention in currency markets only led to short-term respite.

Finally, the prize for most dramatic performance of the year goes to the Swiss Franc. The CHF appreciated strongly, particularly against the Euro, as the Eurozone crisis escalated. Deposit flight from peripheral banks along with general flight to quality by investors had the CHF up 24% on a trade weighted basis by August. Cutting interest rates to zero did little to deter investors, and in the end, it was the Swiss National Bank's intervention in the currency market against the Euro which was effective - announcing that it would defend the level of 1.20 with unlimited resources. Since then, the CHF has fallen back some 22%, and will only show a small gain on the year.

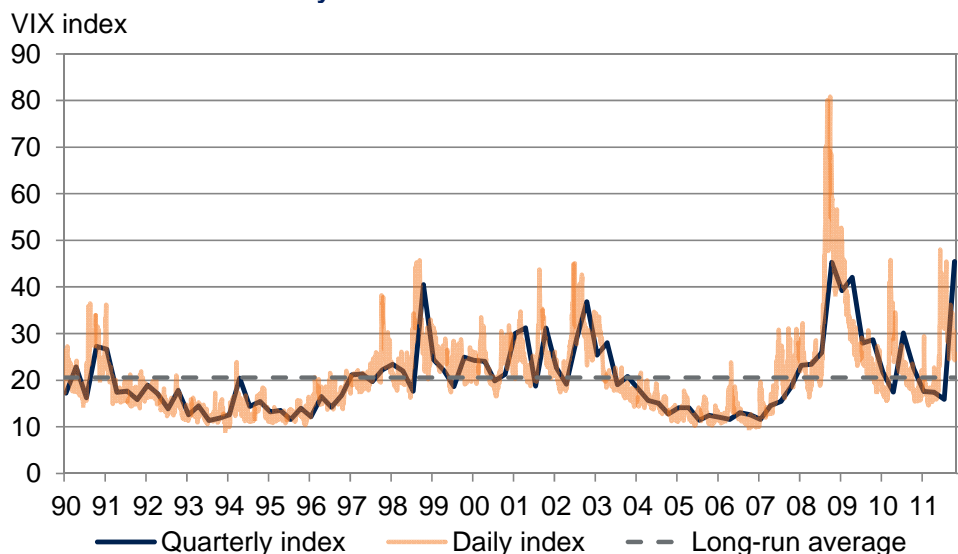
### Where next for markets?

Looking ahead, the four themes discussed in the global section of this publication (stagflation to deflation; the search for yield; Eurozone debt restructuring and financial repression; political risk) should mean that a key feature of markets through the second half of this year should continue into 2012 - higher volatility.

Volatility in the S&P500 index as measured by the daily VIX index did rise this year, though did not spike up by as much as it did in 2008/09. However, volatility has remained high throughout the second half of 2011, causing the quarterly measure to spike up to similar levels seen just after the Lehman Brothers crisis (see chart 8 below).

**Given our themes for 2012, high volatility is likely to remain a feature in market.**

**Chart 8: S&P500 volatility**



Source: Thompson Datastream, Chicago Board Options Exchange, Schroders. Updated 20 December 2011.

With a number of key elections coming up in the first half of 2012, the Greek government debt restructuring deal, and a huge amount of banking and sovereign debt to be refinanced, event risk will be plentiful in 2012.

**With bond yields close to record lows, relative valuations suggest equities are good value**

Looking at relative valuations, equities are once again yielding significantly more than government bonds - usually a sign of recession or crisis (chart 9 for the UK). It is not quite correct to expect the yield differential between equities and bonds to mean revert as there has been a long-term decline in government bond yields versus equity yields since the inflationary 1970s. However, purely on a short-term valuations basis, one could argue that equities look attractive relative to government bonds. Indeed, with yields close to record lows, how much juice is really left in government bond markets?

**Chart 9: UK Equity vs. government bond yields**

FTSE 100 dividend yield minus UK 10-year govt. bond yields (%)



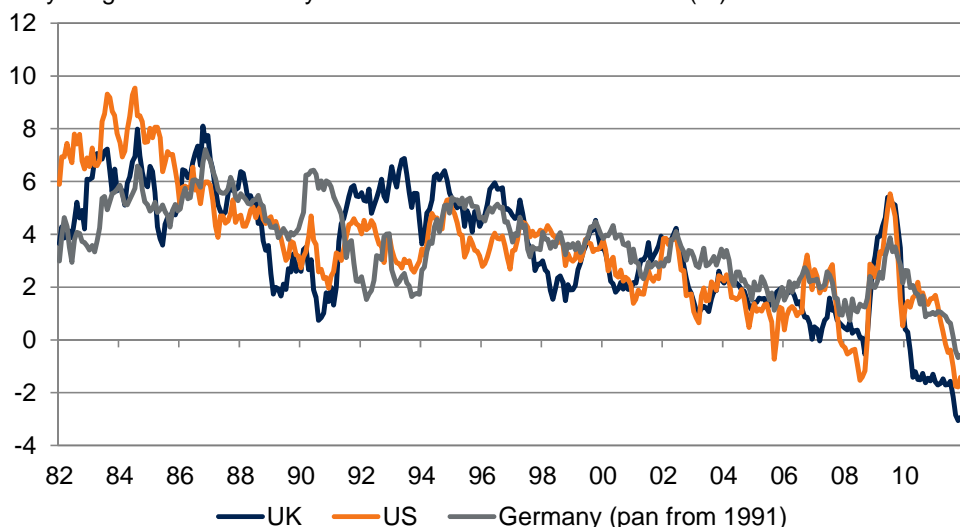
Source: Thompson Datastream, Schroders. Updated 20 December 2011.

When adjusted for inflation, government bonds no longer yield positive returns. Though this occurred in 2008, real yields are now even more negative today (chart 10).

**Government bonds currently do not compensate investors for inflation, with real yields very negative...**

**Chart 10: Real 10-year government bond yields**

10-year government bond yields minus annual inflation rates (%)



Source: Thompson Datastream, Schroders. Updated 20 December 2011. RPI inflation used for UK.

This means that investors are not being compensated for inflation, whilst the term premium has become compressed (the excess return demanded for holding a longer-dated security versus a short dated security). Could this mean that investors will eventually decide that government bonds are too expensive and at some stage switch to other assets?

### Roadmap for 2012

***...however, if our forecasted credit crunch plays out in 2012, then investors could be reluctant to swap their government bonds for risk assets.***

Our themes for 2012 suggest that government bond yields will remain low in the early part of the year with risk off. Lower inflation and slower growth should underpin government bond yields, whilst political risk could well keep risk assets on the sidelines. Peripheral Eurozone bond spreads are likely to remain elevated. Our view that the crisis needs to deteriorate further before decisive action takes place suggests that investors are willing to tolerate negative real yields in the short-run, so that they can preserve their capital for better opportunities further out.

As the year progresses and the macro picture deteriorates we would expect investors to increasingly focus on the likelihood of policy response from the central banks. Markets will begin to see bad data as good in the sense that it brings Quantitative Easing from the US Fed and even the ECB closer. Consequently we could see rallies in risk assets on hints of easier money.

The pressure to find yield combined with attractive risk premiums should draw investors into both equities, credit and carry trades. However, a sustainable rally will need evidence of stronger recovery in the US and a turn in Europe along with signs that policymakers have got to grips with the Euro crisis. We will probably need to wait until the second half of 2012 before we see any clarity on these fronts. Meanwhile, the tail risks remain high and we would still see the Euro break up scenario discussed in the last Viewpoint as more likely than the upside. As a result it will be some time before investors can be prised away from their Treasuries and gilts.

## I. Updated forecast tables

## Forecast table: Baseline

## Baseline

## Real GDP

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus	2013	Consensus
US	26.4	3.0	1.8	1.7	1.7	2.1	2.4	n.a.
UK	4.1	1.8	0.9	0.9	-0.4	0.7	0.9	n.a.
Eurozone	23.5	1.8	1.6	1.6	-1.8	-0.1	0.7	n.a.
Japan	9.5	4.5	-0.5	-0.6	1.8	2.0	1.2	n.a.
OECD	63.5	2.7	1.3	1.3	0.3	1.2	1.5	n.a.
BRIC	21.8	8.9	7.0	7.1	5.8	6.8	6.4	n.a.
Total Emerging*	36.5	7.6	6.0	6.1	4.7	5.5	5.5	n.a.
World	100.0	4.5	3.0	3.0	1.9	2.8	3.3	n.a.

## Inflation CPI

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus	2013	Consensus
US	26.4	1.6	3.0	3.2	1.6	2.1	1.0	n.a.
UK	4.1	3.3	4.5	4.5	1.9	2.7	1.6	n.a.
Eurozone	23.5	1.6	2.7	2.7	1.6	1.8	0.8	n.a.
Japan	9.5	-0.7	-0.2	-0.2	-0.2	-0.2	-0.2	n.a.
OECD	63.5	1.4	2.5	2.6	1.3	1.7	0.8	n.a.
BRIC	21.8	5.4	6.3	5.4	4.7	5.0	4.8	n.a.
Total Emerging*	36.5	5.2	5.9	5.3	4.9	5.1	4.9	n.a.
World	100.0	2.8	3.7	3.6	2.6	2.9	2.3	n.a.

\* Emerging markets: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Slovakia, Romania, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

## Interest rates

%	Wt (%)	Dec-10	Dec-11	Market	Dec-12	Market	Dec-13	Market
US	26.4	0.25	0.25	0.56	0.25	1.92	0.25	2.99
UK	4.1	0.50	0.50	1.08	0.50	1.08	0.50	1.13
Eurozone	23.5	1.00	1.00	1.41	1.00	1.04	1.00	1.28
Japan	9.5	0.10	0.10	0.33	0.10	0.35	0.10	0.41
OECD	63.5	0.52	0.52	0.88	0.52	1.31	0.52	1.85

Market data as at 14/12/2011

## Key variables

FX	Current	Dec-10	Dec-11	y/y%	Dec-12	y/y%	Dec-13	y/y%
USD/ GBP	1.55	1.60	1.55	-3.1	1.45	-6.5	1.50	3.4
USD/ EUR	1.30	1.34	1.30	-3.0	1.15	-11.5	1.20	4.3
JPY/ USD	78.0	83.0	75.0	-9.6	70.0	-6.7	70.0	0.0
GBP/ EUR	0.84	0.84	0.84	0.1	0.79	-5.4	0.80	0.9
Brent crude	106.2	87.2	110.0	26.1	101.2	-8.0	97.4	-3.8
US output gap								
%GDP	-5.5	-6.4	-4.8		-5.1		-4.4	
Unemploy. %	9.1	9.6	8.7		9.0		8.6	

Source: Schroders, Datastream, Consensus Economics, December 2011

## Baseline - Eurozone credit crunch, both Fed and ECB embark on QE

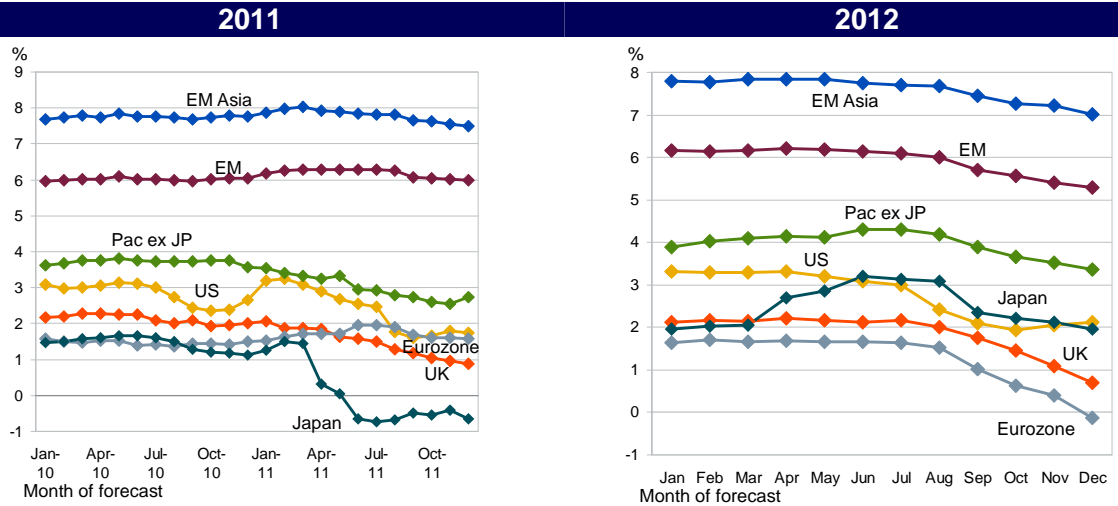
- Following last month's downgrade to global growth, our forecasts this month are little changed with GDP growth expected to slow from 3% this year to just under 2% in 2012. This compares with a consensus of 2.8% growth and is mainly driven by our negative view on the Eurozone which is expected to experience a significant recession in 2012. At the other end of the spectrum Japan is expected to be one of the stronger developed economies as reconstruction spending lifts growth to nearly 2%.
- On inflation we expect 2.6% next year after 3.7% in 2011 - also below consensus. The fall is driven by a combination of lower commodity prices and a weaker core rate.
- As a consequence of our more deflationary outlook we expect monetary policy to loosen further with the Fed, ECB and Bank of England all engaging in quantitative easing.
- In the emerging markets, where we also see growth running below consensus and a fall in inflation, policymakers are expected to sanction cuts in interest rates and bank reserve requirements.
- This month we have extended our forecasts into 2013 when we expect some stability in the world economy. The move to QE by the ECB proves to be effective in bringing down sovereign bond yields in the peripheral Eurozone economies. European bank deleveraging is moderated by aggressive liquidity provision. However, fiscal tightening is still expected to weigh on growth with the result that the recovery is subpar, unemployment remains high and inflation falls further.
- The principal risks to these forecasts come from an even worse outcome in the Eurozone (with the possibility of a breakup of the single currency) and the threat of a hard landing in China. Both would tend to reinforce the deflationary bias of our forecasts. On the upside there is the possibility of a muddle through scenario where policymakers do the right thing in supporting activity and acting to end the euro crisis.

21 December 2011

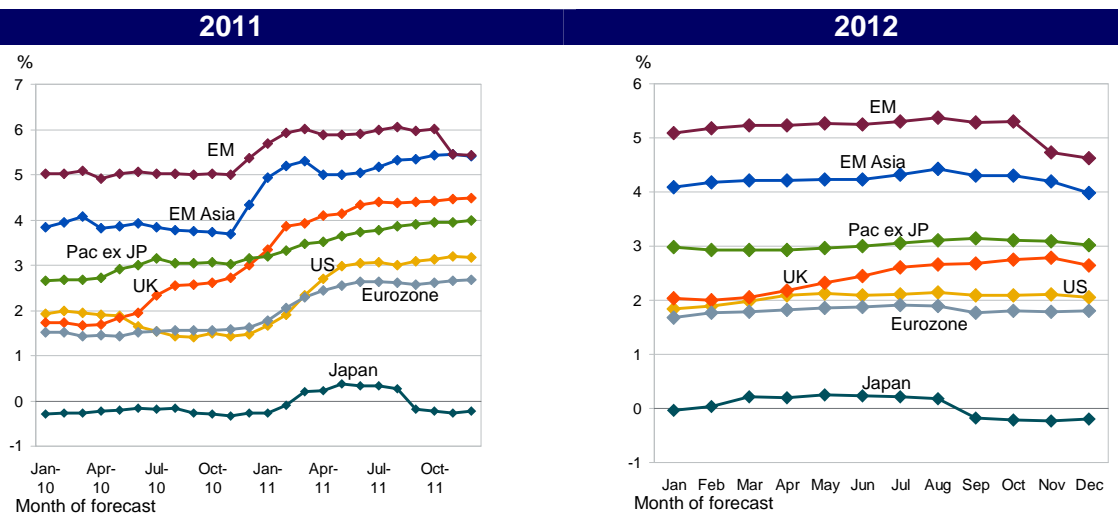
## II. Updated forecast charts - Consensus Economics

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

### Chart A: GDP consensus forecasts



### Chart B: Inflation consensus forecasts



Source: Consensus Economics (December 2011), Schroders  
 Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore  
 Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand  
 Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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