

Schroders

Economic and Strategy Viewpoint

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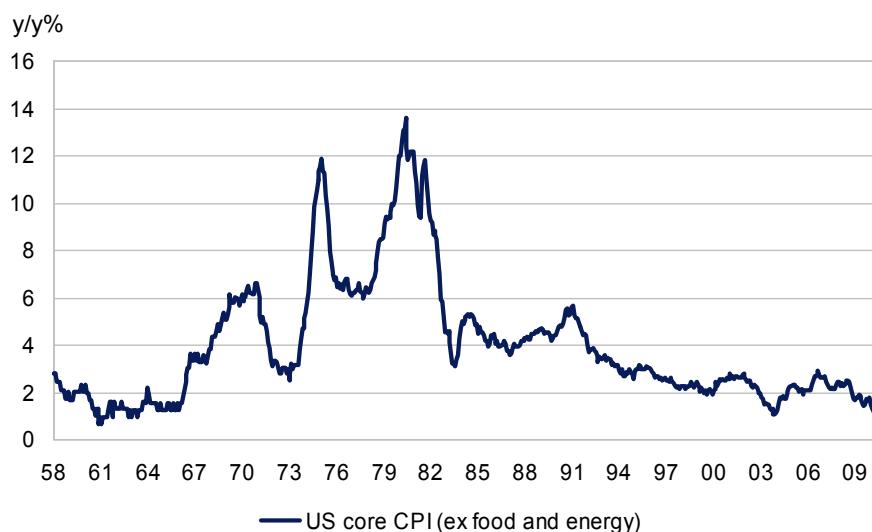
Global: New cycle for the world economy

- After the deepest and longest recession in post war history one might have thought that an extended period of expansion was on the cards. This was the pattern in the 1980s and 1990s as the economy had plenty of slack to grow without creating inflation.
- However, whilst there would seem to be ample capacity for the economy to grow today, there are doubts about whether we will see an extended cycle. Concerns about structural unemployment and the growth of demand suggest we are in for a shorter, more volatile expansion. Constraints on fiscal and monetary policy indicate that the scope for countercyclical policy is limited.
- On this basis, even though we continue to forecast growth for the rest of this year and 2011 (see forecast update), the next recession may be closer than expected. With the Federal Reserve now becoming concerned about inflation being too low, the tightening cycle, when it comes, could be very short lived.

UK: Can the private sector absorb the coming public sector job losses?

- As the government prepares to unveil where the axe will fall on departmental spending (the Comprehensive Spending Review is due 20th October), we examine whether the UK can create enough private sector jobs to offset the OBR's forecast of 490,000 public sector job cuts by 2014.
- Using three different approaches, we conclude that the private sector can create enough jobs not only to cover the public sector job cuts, but also to ensure unemployment falls over the coming years.
- Falling unemployment means increased incomes for the household sector overall, which should support private consumption growth. However, we continue to expect a sub-trend recovery where households hold back spending as they continue to deleverage, and struggle to access new credit.

Chart: Too low for the Fed: US core inflation heading toward fifty year lows.



Source: Thomson Datstream, 27 September 2010



Global

New cycle for the world economy

Official: the financial crisis triggered the worst recession since WW2

Some good news: the National Bureau for Economic Research (NBER) has announced that the US recession officially ended in June 2009. The economy troughed in that month and the expansion began. Whilst it may seem incongruous that academics at the NBER are making such an announcement at a time when markets are focussed on the risk of a double dip – it certainly provides a measure of the impact of the financial crisis.

Activity peaked in December 2007 thus making the last recession 18 months in length and the longest since World War II, just ahead of the downturns in 1973-75 and 1981-82. In terms of lost output it was also the most severe during that period. Real GDP fell 4.1% compared with 3.2% in the 1970's and 2.6% in the 1980s.

Long recession = long expansion?

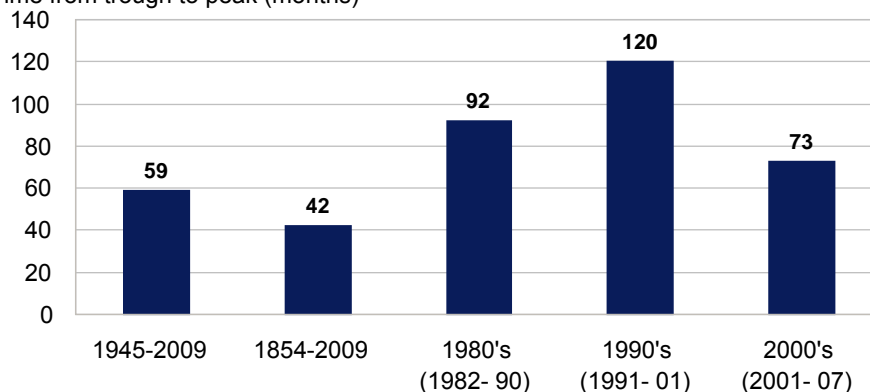
Arguably a long deep recession should be followed by an extended period of growth. The economy has plenty of spare capacity to absorb the pick up in demand without hitting the inflationary buffers. This was the pattern in the 1980's expansion which followed the deep inflation-busting recession at the beginning of the decade (sometimes known as the "Volcker recession" after the then chair of the Federal Reserve, now a member of the Obama administration), and in the 1990's expansion. Subsequent recessions were shallower, but the lack of inflationary pressure in the world economy, often attributed to globalisation, meant that expansions were long.

Recent expansions have been longer than average

From trough to peak the US economy grew for 92 months in the 1980's, 120 months in the 1990's and 73 months in the 2000's. The average expansion since 1854 lasted 42 months, so recent expansions have been more than twice as long as the historical average (see chart 1). The period as a whole from the end of the Volcker recession until 2007 has been described as a golden age for growth.

Chart 1. Length of US economic expansions

Time from trough to peak (months)



Source: National Bureau of Economic Research (NBER)
Average length of expansion for periods: 1945 – 2009 and 1845 – 2009

An end to the Golden Age

Today there are doubts about whether we will see a repeat of the long expansions which have characterised recent decades. There are concerns on both the supply and demand sides of the equation.

Lack of capacity and....

The structural nature of the downturn means that the amount of spare capacity in the economy is not as great as suggested by headline unemployment rates. For example, following the financial crisis many jobs in construction and finance will not be coming back. Consequently workers will have to retrain and relocate to find employment, a process which will take time and mean higher structural unemployment for a period.

There are concerns that such an effect can already be seen in the UK where inflation has consistently surprised on the upside over the past two years, taking CPI inflation above 3% and causing the Governor of the Bank of England to increase his correspondence with the Chancellor. In the last Inflation Report the Bank attributed part of the overshoot of inflation to temporary factors such as higher oil prices and a weaker pound, but acknowledged that a lack of spare capacity may have also played a role.

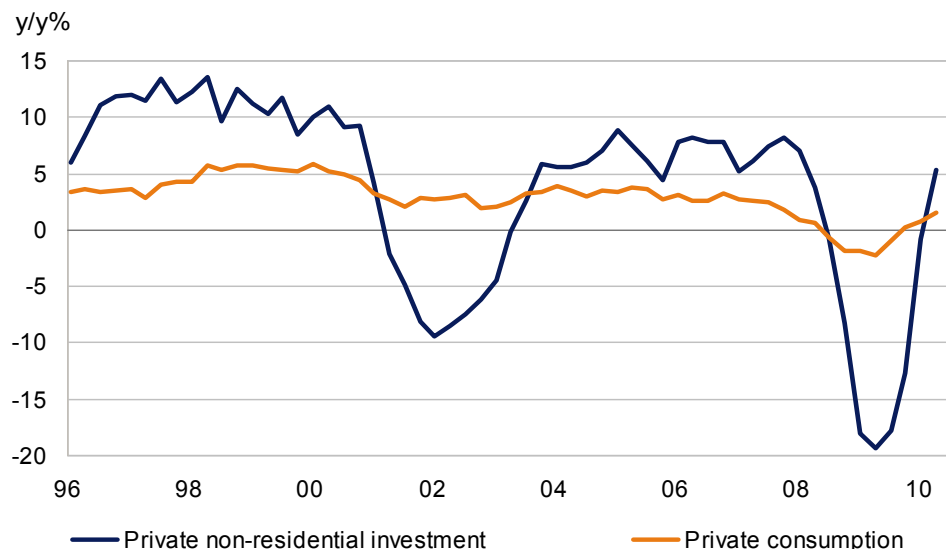
We recognise these arguments, but given the weakness of wage growth in both the US and UK, we still believe that there is substantial spare capacity in the labour markets of those economies. US and Eurozone inflation remains weak and is expected to moderate in the UK.

...lack of demand could constrain the cycle

The greater threat to the cycle is the lack of demand. The post crisis economy is characterised by a period of de-leveraging as households, and now government's seek to repair their balance sheets and reduce gearing. The build up of debt which fuelled growth during the great moderation is now reversing leaving a shortfall in demand. Monetary policy is severely constrained and while we expect another round of Quantitative Easing (QE2) from the US Federal Reserve the impact on growth is, in our opinion, expected to be negligible.

Making the economy more dependent on investment and exports

This suggests an economy where growth is primarily driven by corporate investment spending and exports, rather than consumer and government expenditure. If monetary policy is ineffective and fiscal policy constrained by concerns over the level of debt, we face an economy where the authorities are less able to offer counter cyclical support. So not only is growth likely to be slower, but it will also be more volatile being driven by swings in investment and world trade. Investment spending in particular tends to be one of the most volatile components of demand (see Chart 2). That suggests activity will be more vulnerable to swings in business sentiment, making for a world of shorter cycles.

Chart 2. US consumption and investment

Source: Thomson Datastream, 22 September 2010

Rather than the economy expanding until inflationary pressures rise such that policy tightening brings an end to the cycle, we are more likely to see cycles ending as demand slows, either naturally through the ebb and flow of the investment cycle or as a result of an external shock.

New forecasts

New balance of demand is reflected in our forecasts

The current situation gives an immediate example of this changing balance of growth with the corporate sector set to play a major role in the recovery as the increase in profitability feeds through into capital expenditure and higher employment. Our updated forecasts assume that this effect is sufficient to offset the headwind from fiscal tightening and continued de-leveraging in the household sector, so avoiding a double dip. Consumer spending grows, but only in line with income growth whilst government spending, particularly on investment is expected to slow. The risk to this forecast is that animal spirits fail and the corporate sector decides to sit on its cash, rather than spending and supporting growth. For full details of our forecasts see page 10.

On the basis that we are in a world of shorter cycles the next recession may not be far off. For example, if we were to take the long run average cited above of 42 months from trough to peak, the expansion would end in December 2012 and the next recession begin in January 2013. That would be considerably earlier than the experience of recent decades.

Markets in a world of shorter cycles

Monetary policy would move in line with the shorter economic cycle. The policy tightening, which we have beginning in September 2011, would be drawing to a close just over one year later. Central banks would be easing again in 2013 as growth slows. Inflation is not likely to be a problem as the short period of expansion will make little impact on unemployment. Indeed deflation could be the bigger worry given the low starting level of inflation. As a consequence, low bond yields may be with us for some time as the market continues to discount a lower

profile for rates. Such an outcome would be reinforced if central banks hold back from tightening too aggressively for fear of causing deflation.

As for equity markets, a period of slower, but more volatile growth would suggest that a higher risk premium will be required relative to cash or government bonds. Some western companies may escape the limitations of their domestic economic cycles by tapping into overseas demand, particularly in the emerging markets where growth should be stronger and more consistent. Others will be more constrained. Markets are already beginning to price companies with emerging market exposure more highly than those with a domestic bias.

UK

UK: Can the private sector absorb the coming public sector job cuts?

With the Comprehensive Spending Review due to be held on the 20th October, markets, the public and government departments will finally learn how Chancellor George Osborne plans to deliver over 80% of the fiscal austerity that he promised at his Emergency Budget in June.

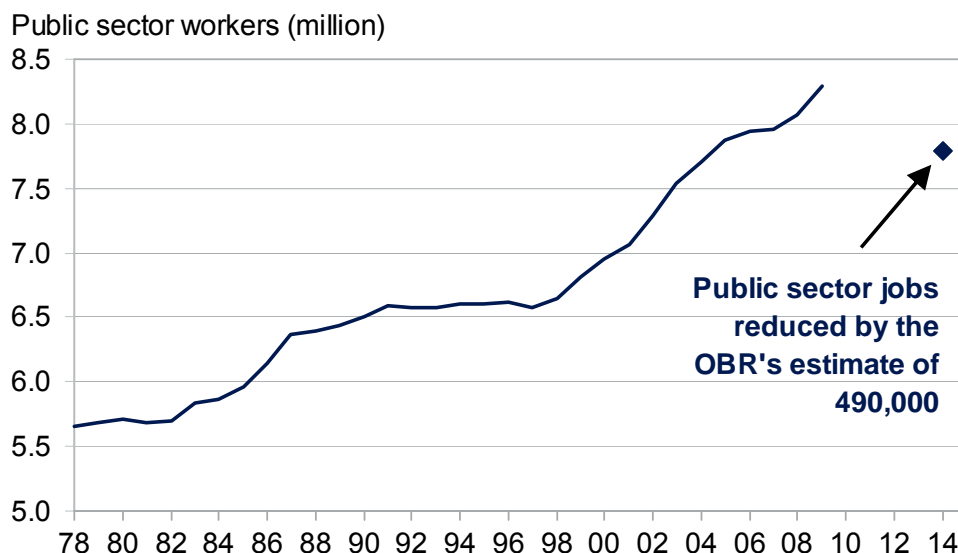
Fear has engulfed Whitehall as some departments rush to strike early deals with the Treasury, while others release scare stories about the impact of the cuts to come. Though the UK may soon be over-run by criminal youths, the biggest talking point of late is how the economy will be able to withstand public sector job cuts that will inevitably follow.¹

Is the OBR's forecast too optimistic?

The Office for Budgetary Responsibility (OBR) recently published estimates of the number of jobs lost by 2014-15 due to the austerity measures announced at the Emergency Budget. The estimate of 490,000 job losses by 2014 is approximately equal to a 6% reduction in the total workforce (see chart 3).

490,000 Public Sector jobs to go, but can the economy cope?

Chart 3: Forecasted cut in public sector employment



Can we rely on the OBR's forecast?

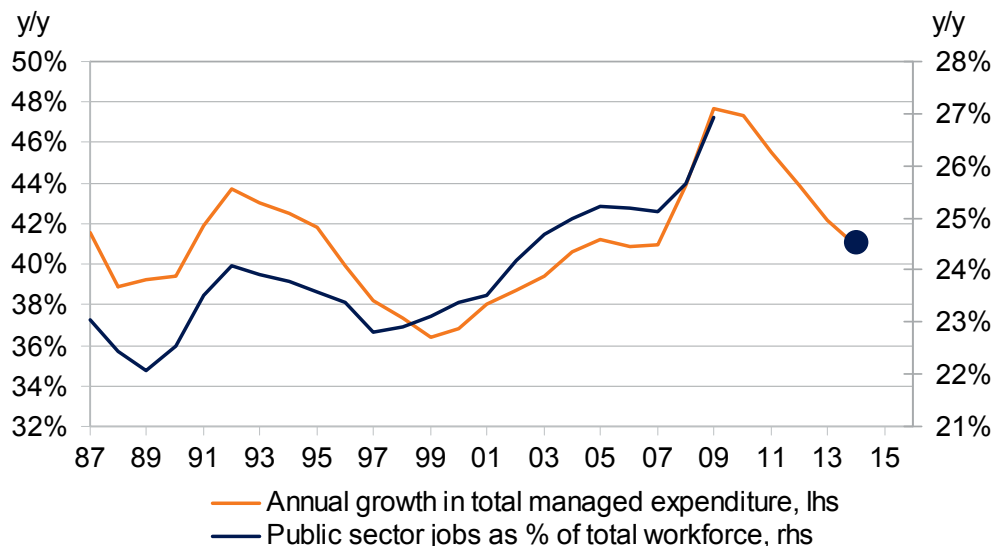
The OBR came under pressure after it was revealed that it reduced its forecast by 175,000 after it pre-emptily included savings from public pension reforms that had not yet been announced. But how many jobs are likely to go, and will unemployment begin to rise once again?

Our starting point is to look at the number of public sector workers as a proportion of the total workforce, and compare that to government expenditure as a proportion of the size of the economy (total managed expenditure as % of GDP).

¹ Senior Scotland Yard officials warning that youth crime would sky rocket if Police numbers are cut.

Chart 4 shows that the two ratios have a close relationship. As public spending rises as a proportion of the economy, the proportion of the workforce that is employed by the state also rises. Looking ahead, the OBR forecasts public spending to fall markedly by 2014-15 from 47.7% of GDP to 40% if GDP. As a result, we would then expect the proportion of public sector jobs to fall from 26.9% to 24.5% of the total workforce.

Chart 4: Public sector jobs vs. public spending



Source: ONS. Updated 24/08/2010

At worst 750,000 jobs could go, but this is based on unrealistic assumptions

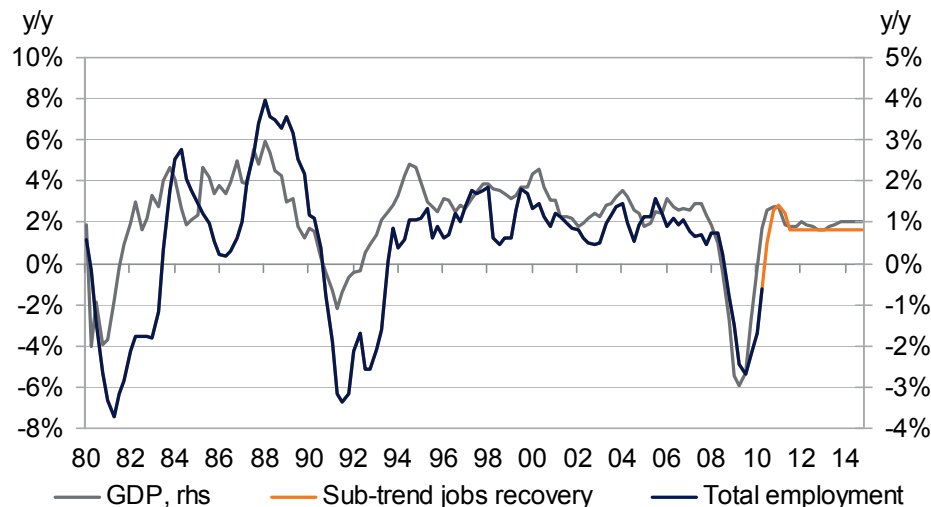
What this means in terms of job cuts depends on the assumption made on the number of private sector jobs created. If we take the very pessimistic assumption that there is no growth and are no private sector jobs created between the end of 2009 and 2014, then Chart 1 would imply 750,000 public sector job losses. However, assuming no private sector jobs growth is unrealistic. In fact, over the first two quarters of this year, the private sector has added 343,000 new jobs already.

How many private sector jobs can we expect?

The next question to ask is assuming a jobs recovery consistent with our sub-trend economic recovery; can the private sector add enough jobs to offset the 490,000 losses forecast by the OBR?

Chart 5 (next page) shows our GDP forecast until 2014, along with the sub-trend employment recovery to match. We assume employment growth peaks at 1.4% at the start of 2011, before falling back to 0.8% annual growth from there on. Note that this is below the 1% annual average (1993-2007) we would normally assume if this was a normal recovery.

Chart 5: Total employment vs. GDP growth



Source: ONS, Schroders. Updated 24/08/2010

Assuming a sub-trend jobs recovery, the Private Sector would more than offset Public Sector job losses

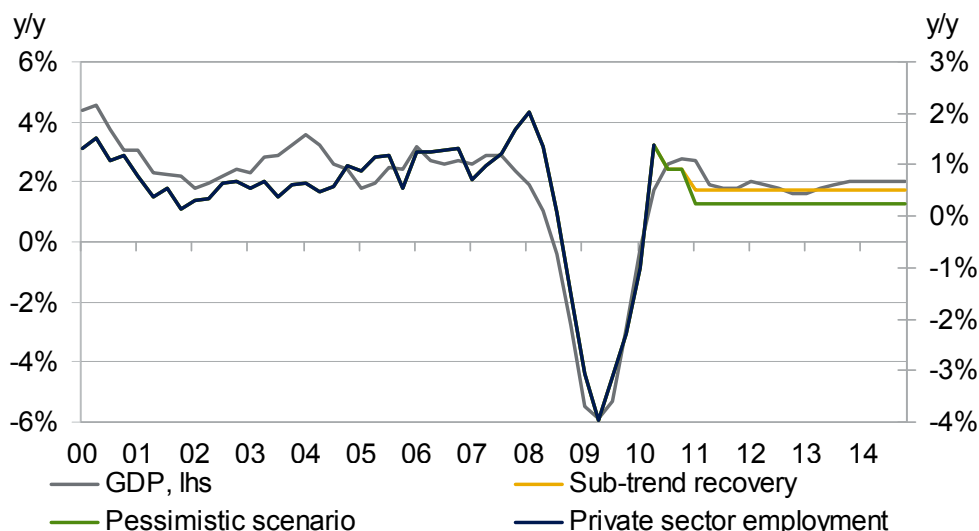
Based on the above, we would expect a total of 1.36 million jobs to be created between the end of 2009 and 2014 – easily above the 490,000 public sector job losses estimated by the OBR, and the 750,000 from our pessimistic scenario above (see table 1 below).

Table 1: Assumed changes using total employment recovery (thousands)

	2009	Change in jobs	2014
Public sector	8,285	-490	7,795
Private sector	22,468	1,850	24,318
Whole economy	30,753	1,360	32,113

An alternative approach to looking at whether the private sector can offset the public sector job cuts is by looking at private sector jobs growth directly. Data for private sector jobs does not go back beyond 1999, and so does not allow us to look at past recessions. However, using the same technique of chart 2, we can look at assumed GDP growth, and look at two scenarios: a scenario that is consistent with a sub-trend recovery; and a scenario that is even more pessimistic.

Chart 6: Private sector employment growth



Source: ONS, Schroders. Updated 24/09/2010

Between 1.7 and 2.7 million new private sector jobs may be added....

Chart 6 shows current private sector employment growth running at 1.4% for 2010Q2. We assume that this slows to 0.9% for the rest of this year, but then to 0.5% for the sub-trend recovery, and to 0.25% for the more pessimistic scenario. The results are positive. The sub-trend recovery yields 2.7 million new private sector jobs, while the more pessimistic scenario yields 1.7 million new jobs – both higher than the OBR’s 490,000 public sector job cuts estimate, and the pessimistic estimate of 750,000 shown earlier.

Table 2: Private sector jobs assumptions & outcomes (thousands)

		Sub-trend recovery		Pessimistic scenario	
	2009	Change in jobs	2014	Change in jobs	2014
Public sector	8,285	-490	7,795	-490	7,795
Private sector	22,468	2,715	25,183	1,720	24,188
Whole economy	30,753	2,225	32,978	1,230	31,983

Conclusions

We expect private sector jobs growth to more than offset the cuts in public sector jobs assumed by the OBR, even if the OBR’s estimate proves to be optimistic. It is also worth noting that almost 60% of the rise in public sector employment in 2008 and 2009 has been due to the reclassification of nationalised and part-nationalised banks as public entities. This is equated to roughly 200,000 workers, most of which will be re-classified again as private sector workers once the banks are sold again.

which means unemployment should fall, albeit slowly by historical standards

The results mean that total employment can continue to rise while public sector jobs are being cut, which will boost aggregate household sector income as we showed in the July Economic & Strategy Viewpoint. However, we continue to expect a sub-trend recovery in the labour market. Therefore, unemployment will not fall as quickly as it has done following past recessions, which will cause households to hold back spending as they continue to deleverage, and struggle to access new credit.

Forecast Summary

I. Forecast summary

Real GDP						
y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus
US	27.3	-2.6	2.5	2.7	2.5	2.4
UK	5.1	-4.9	1.6	1.5	2.1	2.1
Eurozone	25.8	-4.0	1.7	1.6	1.4	1.4
Japan	9.3	-5.2	2.7	3.0	1.2	1.3
Australia	1.9	1.3	3.0	3.3	3.2	3.4
OECD	69.5	-3.5	2.2	2.2	1.9	1.9
China	8.2	8.6	10.0	9.9	8.8	9.0
Emerging*	30.5	1.1	6.5	6.6	5.5	5.6
World	100.0	-2.1	3.5	3.6	3.0	3.1
Inflation CPI						
y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus
US	27.3	-0.3	1.5	1.6	1.0	1.4
UK	5.1	2.2	3.1	3.1	2.9	2.6
Eurozone	25.8	0.3	1.8	1.5	1.3	1.6
Japan	9.3	-1.1	-1.0	-0.9	-0.3	-0.3
Australia	1.9	1.8	2.6	3.0	3.0	3.0
OECD	69.5	0.0	1.4	1.4	1.1	1.4
China	8.2	-0.7	3.2	3.0	3.0	3.1
Emerging*	30.5	4.3	5.2	5.4	5.0	5.0
World	100.0	1.4	2.6	2.6	2.3	2.5

* 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, Estonia, Latvia, Lithuania

Interest rates

%	Wt (%)	Dec-09	Dec-10	Market	Dec-11	Market
US	27.3	0.25	0.25	0.39	1.00	0.80
UK	5.1	0.50	0.50	0.79	1.25	1.35
Eurozone	25.8	1.00	1.00	1.01	1.50	1.40
Japan	9.3	0.10	0.10	0.35	0.10	0.33
OECD	67.5	0.53	0.53	0.65	1.09	1.00

Market data as at

21/09/2010

Key variables

FX	Current	Dec-09	Dec-10	y/y%	Dec-11	y/y%
USD/ GBP	1.56	1.62	1.55	-4.4	1.45	-6.5
USD/ EUR	1.31	1.46	1.25	-14.2	1.18	-5.6
JPY/ USD	85.1	90.0	85.0	-5.6	90.0	5.9
GBP/ EUR	0.85	0.90	0.81	-10.3	0.81	0.9
Brent crude	78.6	74.9	74.1	-1.0	75.8	2.2
US output gap %GDP	-7.0	-8.0	-6.8		-5.3	
Unemploy. %	9.7	10.0	9.7		9.1	

Source: Schroders, Datastream, IMF, Consensus Economics (September 2010)

Real GDP, inflation CPI, interest rates and key variables (August 2010)

- Having made substantial revisions to our forecasts in recent quarters this time our figures are little changed. Our forecast for global growth in 2010 has ticked down by just 0.1% to 3.5%. Growth prospects in the US, China and emerging markets have been downgraded to reflect the mid-year slowdown and a more difficult outlook, whilst the UK and Eurozone have been upgraded to reflect a better than expected recent performance.

- Our forecasts for 2011 are also marginally lower (3% versus 3.2% in June) with a moderation in growth expected as fiscal stimulus fades and the de-leveraging process continues to hold back consumer spending. We are not forecasting a double dip, but do expect a period of sub-trend growth over the next two quarters.

- We do not believe that the Euro crisis is over and expect concerns over solvency to return later in 2010. However, we expect contagion to be limited by EU/ IMF support.

- On the price front, we have edged our global inflation forecast down to 2.6% for 2010. Generally, inflation is coming in as expected with a moderation in US core inflation.

- The exception continues to be the UK where we have increased our forecast for inflation once more following a run of higher than expected outcomes, which indicate there is less slack in the economy than widely believed. We have also raised our inflation forecast for next year to reflect the VAT hike from 17.5% to 20% - slightly more than expected before the June budget.

- We continue to forecast a further rise in inflation in China, before a slowdown in growth helps moderate price pressures later in the forecast.

- For 2011, we expect global inflation to decline to 2.3% primarily led by the US and Europe as commodity price gains moderate and core inflation recedes further.

- Although our forecasts for global growth and inflation are little different, monetary tightening is delayed as a result of low inflation and concerns about the fragility of the recovery.

- We now expect the Federal Reserve and ECB to raise rates in September next year. Rate rises are also delayed in the UK, but the need to contain inflation expectations results in the Bank of England raising rates in August next year.

- We continue to expect the USD to strengthen against the EUR as concerns about sovereign risk return to peripheral Europe later this year. The USD is also expected to firm against the GBP in 2011 as fiscal tightening bites and UK growth lags.

September 2010



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

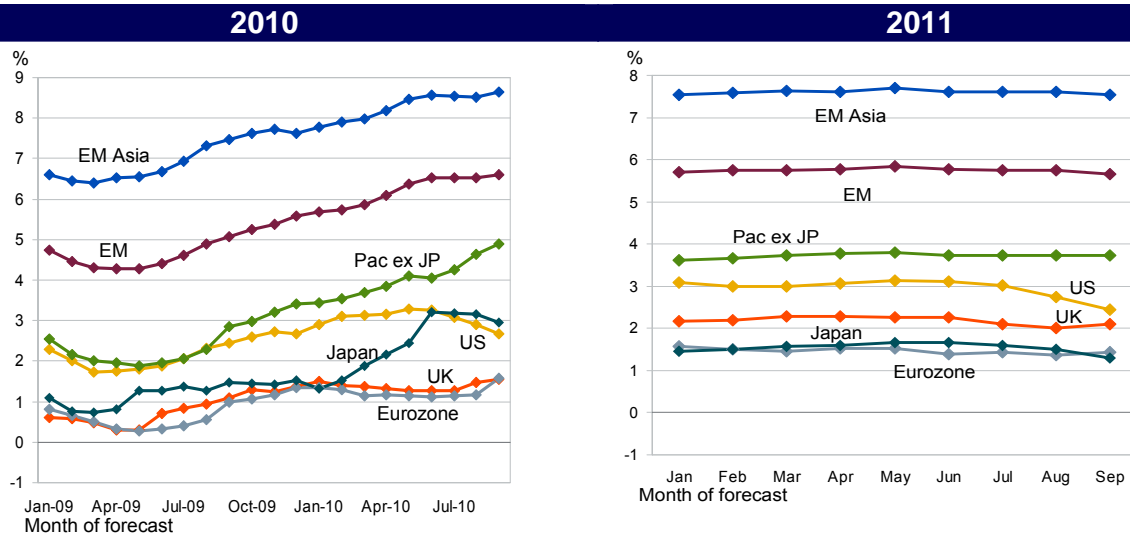
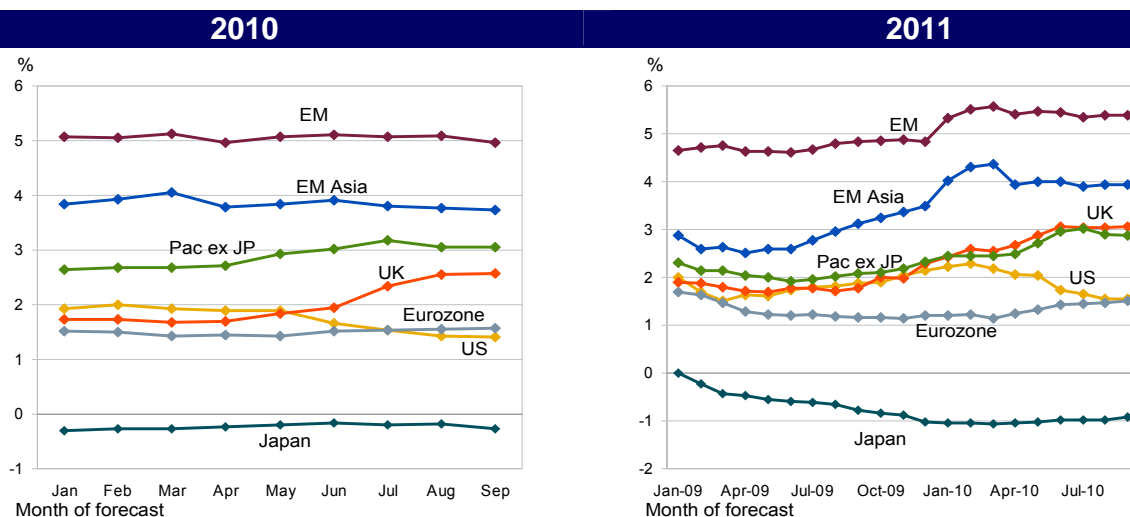


Chart B: Inflation consensus forecasts



Source: Consensus Economics (September 2010), Schroders
 Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
 Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand
 Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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