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2011: A year in the global economy

Keith Wade, Chief Economist and Azad Zangana, European Economist, look ahead into 2011



- Austerity will be a key theme for 2011, with the UK and peripheral Europe being the main focus
- Any benefit from QE2 to the US is largely through the fall in the dollar
- China has also benefitted from this, but will struggle to prevent liquidity from spilling over into asset bubbles and inflation
- The recovery, albeit a weak one, will continue, but low interest rates will force investors to continue seeking yield.

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It's very much a case of déjà vu with 2010 ending pretty much the way it started, with a rally in markets and a recovery in the world economy. That's not to say it's been an easy or enjoyable ride. 2010 has been a real roller coaster. At the beginning of the year, it looked like we were in for a decent recovery and people began to anticipate interest rate rises and the central banks initiating exit strategies from their loose monetary policies.

But by the springtime, the euro crisis had erupted; the world economy showed signs of slowing down and any optimism soon faded. Talk began to move towards a double dip and what the authorities could do in terms of more stimulation. As we approach the end of the year, with more quantitative easing coming through, we're beginning to see the recovery pick up again and markets have revived.

Austerity bites: more to come and what does it mean?

Austerity is going to be the big theme of 2011, easily taking pole position as the main barrier to global growth. The focus will continue to be on the peripheral parts of Europe – Greece, Ireland, Spain and Portugal. In particular, the impact of needing to unwind some of the huge borrowing they've amassed over the last decade. This tightening of fiscal policy is going to be a headwind to global growth, but particularly in the UK and eurozone where we expect to see a slowdown in economic activity. It's a key question as to whether they can withstand tightening of fiscal policy.

The exception to that austerity is in the US, where we're looking at an extension of tax cuts. There's very little debate there at the moment about fiscal tightening.

Quantitative easing: does it still have a place?

As the markets expected, quantitative easing restarted in the US but a surprise this time around was the impact it had on the rest of the world. Currency appreciation and an ever increasing risk of growth stalling elsewhere led to the start of the 'currency wars'.

Beyond the fall in bond yields and the dollar, we don't see there being much further impact from QE2, certainly not while banks refuse to lend and more importantly while households and corporates continue to have little appetite for borrowing. Emerging markets have fast become the destination for investors forced to search for yield. However, the creation of huge capital flows is causing liquidity problems and inflation is beginning to pick up too.

Currency wars: who will win the war?

The focus of the currency war has really been on the fall in the dollar, but against that we've seen a rise in the euro, the yen and the Australian dollar. That increase in currencies is going to squeeze growth in the eurozone, Japan and Australia, so there's a real battle going on where everybody is trying to devalue their currency in order to get a bigger share of a shrinking pie. So far it seems the US is winning, while Europe, where there



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is a desperate need for growth is fast becoming the biggest casualty. It is only recently with the crisis in Ireland that the euro has begun to fall again providing some relief to the embattled region.

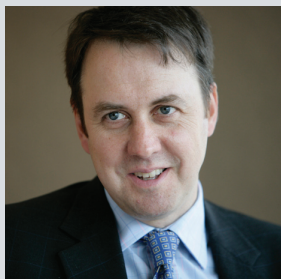
China is benefiting from the fall in the dollar with a currency that is becoming cheaper against the euro and the yen. But the benefits are not without problems. Big capital inflows are creating liquidity problems and asset bubbles, not to mention inflation – and that's something the authorities have to deal with in 2011.

The recovery: where will the search for return be focused?

Going into 2011, we expect to see the recovery continue globally, but especially in the US, which has been boosted by strong profits and healthy balance sheets in the corporate sector. This should see increased capital expenditure and employment, raising growth in the world economy as confidence returns to US consumers. In emerging markets, an enviable fiscal position capable of increasing expenditure in infrastructure will continue to boost growth. Nevertheless, the Fed will be on hold through 2011.

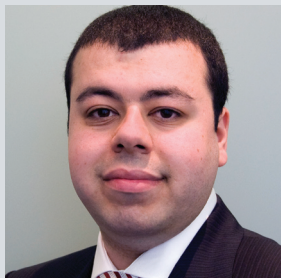
We are expecting a slowdown in Europe and in the UK, mainly because of the spending cuts and tax increases, which will begin to bite into 2011. Given the fragility of the periphery, we do not expect any increases in euro policy rates until 2012.

This continued recovery in growth is important for supporting real assets, but it's not a strong recovery so interest rates are going to stay very low as we go through 2011. That means investors are still going to be searching for yield. Following the rally in bonds we expect investors to rotate out of credit and move into equities and commodities. Emerging markets are likely to continue to attract funds given their growth prospects. These will be our main asset allocation plays as we go into 2011.



Keith Wade – Chief Economist

Keith joined Schroders in 1988 and is Chief Economist. He is responsible for the economics team and the house view of the world economy as well as formulating asset allocation strategies. He became our chief economist in 1992 and commenced his career as a UK economist. Prior to joining Schroders, Keith was a researcher at the London Business School's centre for economic forecasting. Keith holds an MSc and BSc in Economics from the London School of Economics and is a member of the UK Society of Investment Professionals (UKSIP) and the Society of Business Economists.



Azad Zangana – European Economist

Azad is European Economist and joined Schroders in 2009. He is responsible for formulating the house view on the UK and eurozone economies. Azad's investment career commenced when he joined Schroders in 2009. Prior to joining Schroders he was an Economist at HM Treasury working on UK Macroeconomic Analysis and Eastern Europe. Azad holds an MSc in Economics from the University of Southampton and a BSc in Economics from Royal Holloway, University of London.