Schroders
Economic and Strategy Viewpoint

Keith Wade
Chief Economist and Strategist
(44-20)7658 6296

Azad Zangana
European Economist
(44-20)7658 2671

Tina Fong
Analyst, Multi-Asset
(44-20)7658 3278

Harish Vekaria
Quantitative Analyst
(44-20)7658 2722

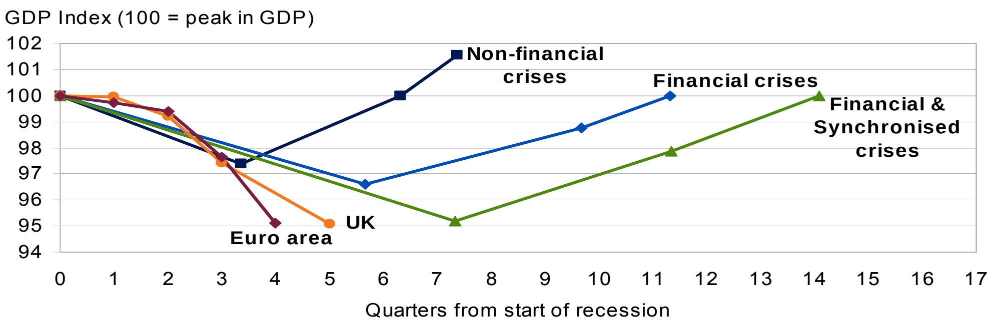
Global: Risk appetite returns, but for how long? (page 2)

- **Increased expectations of recovery, evidence of financial stability and an improvement in liquidity have driven markets over the past quarter. Led by the emerging markets, equities have trounced government bonds and commodity prices have risen as investors have bought into the reflation trade.**
- **Supported by the inventory cycle, recovery expectations are likely to continue to build and there is little sign that central banks are about to turn off the liquidity tap to markets. This would support the reflation trade through the summer.**
- **However, in recent weeks equity gains have slowed, suggesting that investors have begun to question the strength of the recovery. Analysis from the IMF (International Monetary Fund) clearly shows that recoveries from financial crisis are weaker than those in conventional cycles. Periods of synchronised financial crisis, such as the situation today, tend to be the weakest of all (see chart below).**
- **Should the recovery falter, there would be talk of a double dip and deflation. Policy makers would find themselves on the back foot having used most of their ammunition in cutting rates to zero and embarking on Quantitative Easing (QE). Investors have rightly discounted the probability of another Great depression, but are not sufficiently confident to take the next step and price in a robust recovery.**

Focus: Great (inflation) expectations (page 11)

- **It seems only yesterday that worries over deflation dominated sentiments across the world. However higher commodity prices and growing optimism have prompted markets to raise their expectations of inflation over the medium term.**
- **With higher inflation expectations, markets are pricing in earlier rate rises. Futures markets imply rate hikes for the UK as soon as the fourth quarter of this year. We feel this is too soon and the ongoing need for deleveraging will keep rates low.**
- **Ultimately, higher inflation brought about by higher commodity prices, acts as a tax on consumers. Coupled with low capacity utilisation this will mean a very large output gap, which is bound to exert significant deflationary pressure. However, should commodity inflation outweigh the deflationary pressures mentioned above, then the world is in for a painful spell of stagflation.**

Chart: Recessions caused by financial crisis are deeper and recoveries slower



Source: IMF WEO (April 2009), ONS, June 2009, Schroders
Based on 122 observations of recession and recovery in industrial countries since 1960

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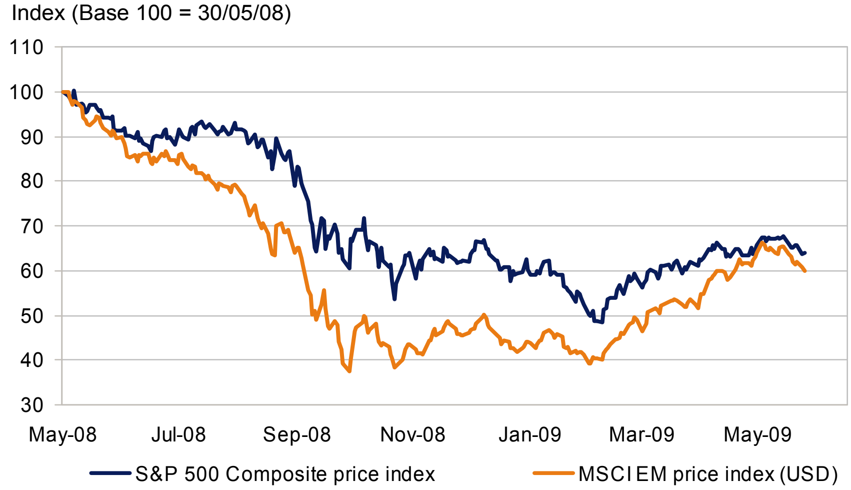
Global

Risk appetite returns, but for how long?

Risk appetite returns in Q2,

Equity markets have been treading water and government bonds have been firmer this month, but the second quarter will be noted for a marked improvement in risk appetite after the dire performance of the first. Since the trough in March, the S&P500 has risen nearly 30% as equity markets have rallied around the world. Emerging markets have been the star performer and are up around 50%. Over the past year there is now little between the two markets as, having fallen more heavily in 2008, the MSCI emerging index has now closed the gap with the S&P500, consistent with its high beta (see chart 1).

Chart 1: US and emerging market equities



Source: Thomson Datastream, 24 June 2009

…led by a rise in Treasury yields

As risk appetite has returned, government bonds have sold off. Arguably, the fall in Treasury prices led the rally in equities as, after hitting lows of 2% in December, the ten-year bond yield has been steadily rising and at one point was approaching its pre-Lehman Brothers bankruptcy level of 4%.

The rise in yields can be almost entirely attributed to higher inflation expectations judging by the gap between nominal bonds and TIPS (Treasury inflation-protected securities) real yields. Having been discounting deflation of minus 1% per annum for the next ten years at the end of 2008, the breakeven rate has risen to a more conventional 2% (chart 2 on next page).

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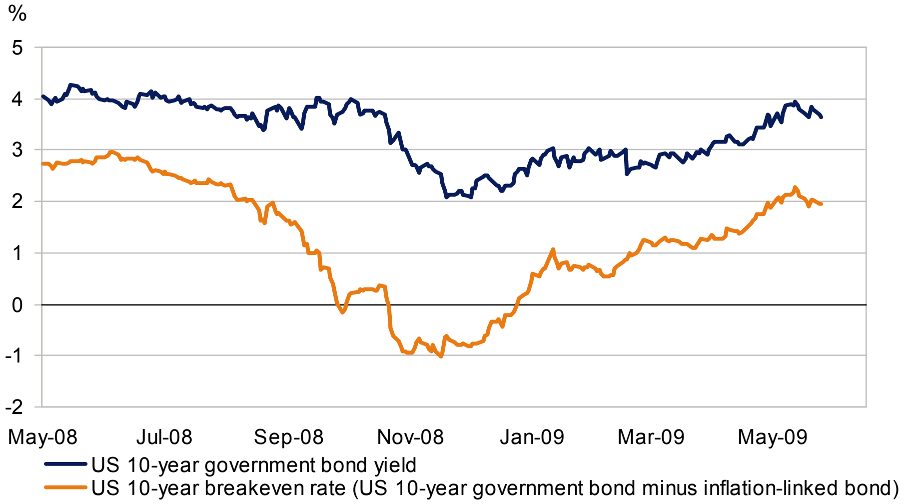
Chart 2: Rising Treasury yields driven by higher inflation expectations

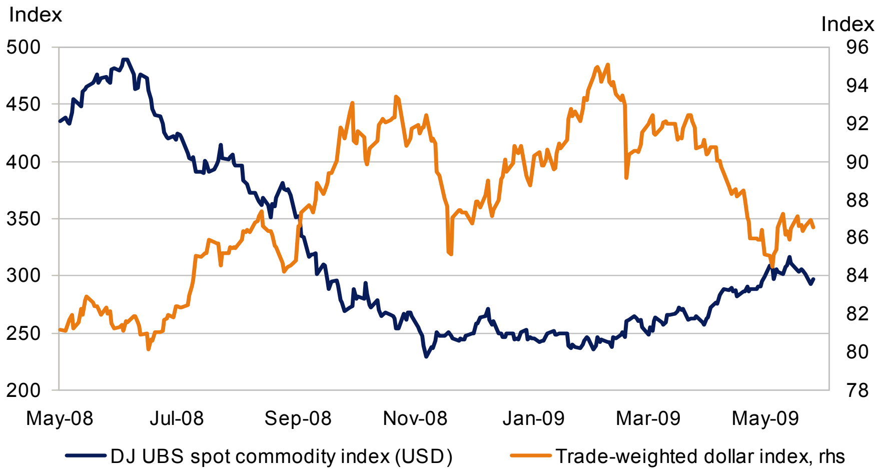


Source: Thomson Datastream, 24 June 2009

…and firmer commodity prices

To complete the picture, commodities have also rallied with the DJ UBS (previously AIG) index rising strongly driven by gains across the board with oil heading toward $70 per barrel. The rise in commodity prices has been helped by a sharp fall in the US dollar (USD), which peaked (in trade-weighted terms) at the end of February (chart 3).

Chart 3: Commodity prices and the US dollar



Source: Thomson Datastream, 24 June 2009

From fears of economic Armageddon to reflation

The combination of rising equity markets, higher government bond yields, increasing inflation expectations and a rally in commodity prices indicates the return of the reflation trade. Risk appetite has risen as investors have reduced their expectation of an economic Armageddon – i.e. a re-run of the Great Depression – and having been stuck in the panic zone the Credit Suisse risk index is now heading toward euphoria (chart 4 on next page). Higher risk appetite has weakened the USD as investors turn away from the safe haven of the US towards riskier assets such as commodities and emerging market equities.

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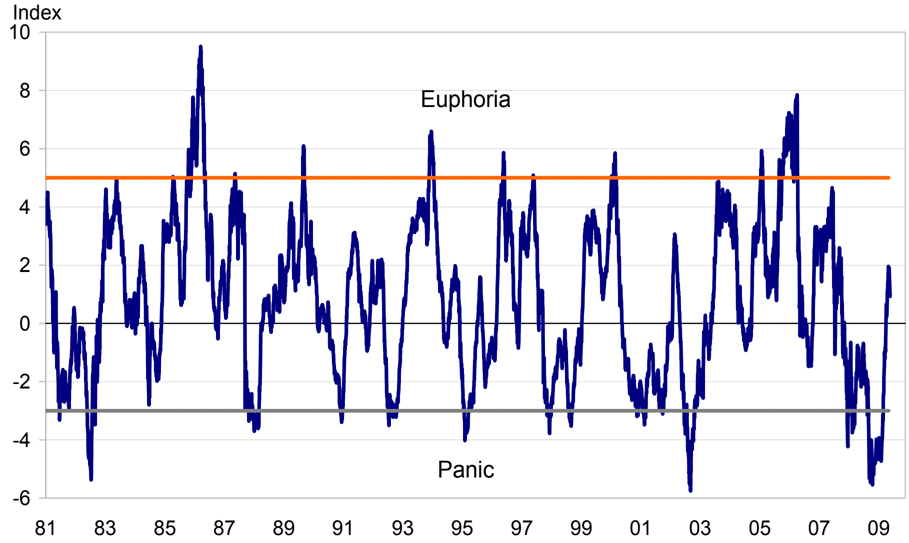
Chart 4: Risk appetite index moves out of the panic zone



Source: Credit Suisse, 24 June 2009

Rally drivers

The key factors behind the return of risk appetite would be:

- The turn in the industrial cycle as signalled by business surveys, purchasing managers indices and the ISM. China's PMI has gone above the critical 50 level that signals expansion and the US is likely to follow.
- Better than expected profits figures, particularly in the financial sector where banks are benefiting from the gap between low funding costs and the rates they charge to lend.
- Increased confidence that policy action will put a floor under activity with central banks cutting interest rates and, in the case of the US and UK, moving to quantitative easing. Action by the US Treasury department has also addressed weaknesses in the banking and credit markets through the stress tests and programs like the TALF (Term- Asset Backed Securities Loan Facility) and PPIP (Public-Private Investment Program).

From a technical perspective, the rally in markets has been helped by:

- An end to forced selling from hedge funds and other leveraged investors, which played a significant part in driving markets down, particularly in the wake of the Lehman crisis. Again, policy makers played a part in this by offering record levels of liquidity as the banking system seized up.

- Liquidity is also receiving a boost from rock bottom interest rates on cash, which are pushing investors into riskier assets as they search for yield. Quantitative easing may also be playing a role. Newly printed money is finding its way into institutional portfolios as the BoE (Bank of England) and Fed (Federal Reserve) buy government bonds and credit (mainly mortgage-backed securities in the US). Since many investors are already cash rich, this increases the pressure to put money to work and while much could simply go back into government bonds, some will leak into riskier assets. Momentum can be a powerful driver in these circumstances as fund managers fear missing the rally.

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How far can this run?

Questioning the recovery

The macro and technical factors driving the rally are unlikely to change in the near term. The turn in the inventory cycle is likely to support activity through the summer, pushing industrial production higher. Business confidence will improve further and fiscal spending will also help activity. Cash rates are not going to change and QE will continue.

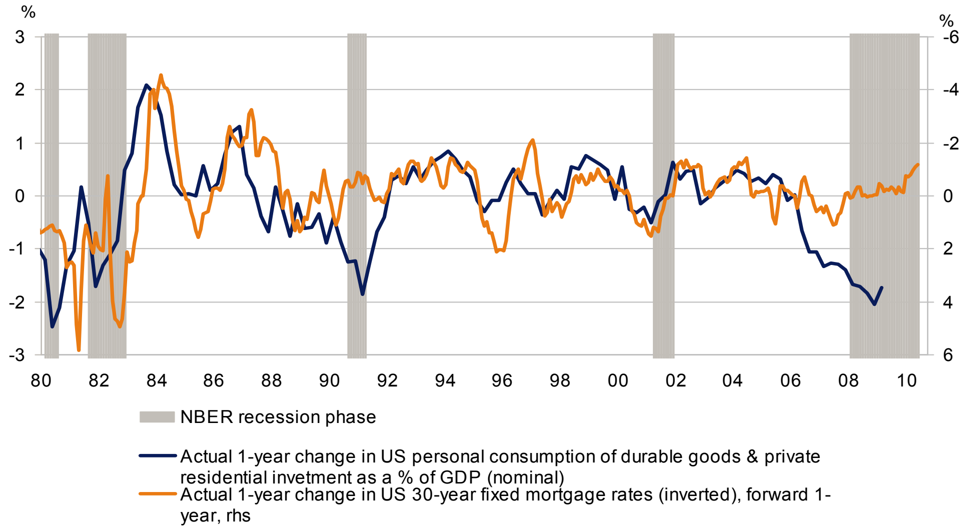
However, we continue to doubt the strength of the upturn in the developed economies. As we said in the last Economic Viewpoint, "the evidence from past financial crisis indicates that the need for balance sheet repair means that recovery tends to be slow to come through. Given the global nature of today's crisis, we do not see why it should be different this time. The first phase of the recession may be ending, but we could be bouncing along the bottom for some time."

Recovery from financial crises tends to be slow, more so when several countries are involved

Such a view is consistent with IMF analysis of downturns and recoveries in industrial economies which highlights the differences between recessions caused by financial crisis and those which have another source. The fact that this is a synchronised financial crisis means that the historical precedents are not good (see chart front page). In the past, economies hit by financial crisis have been able to export their way back to growth, a route that is obviously limited in global downturn like today.

Underpinning this is the lack of feed through from monetary policy to the real economy. The normal multipliers are not working as can be seen from the breakdown in the relationship between lower interest rates and expenditure on housing and durable goods (chart 5). Lending remains weak as banks conserve capital and borrowers are deterred by falling house prices and the fear of unemployment.

Chart 5: Housing and durables not responding to lower interest rates

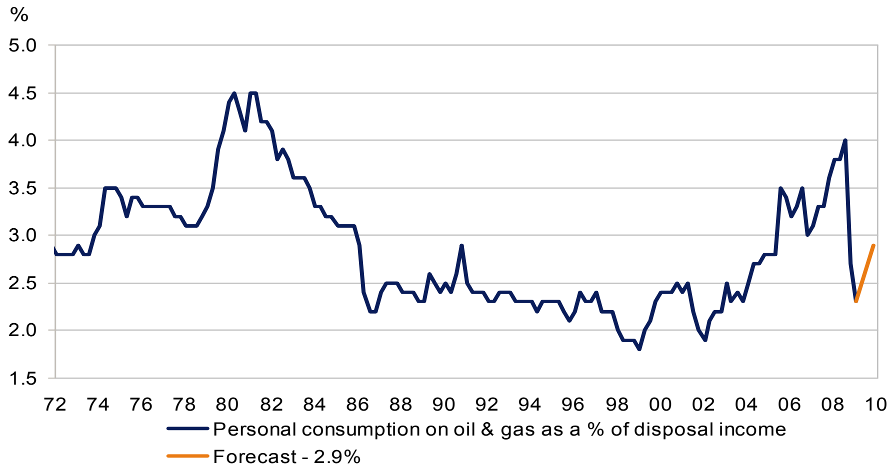


Source: Thomson Datastream, Schroders, 24 June 2009

While recent market developments are welcome it should be noted that higher bond yields and rising commodity prices will work against recovery. For example, the rise in oil prices will absorb around half of one percent from disposable income.

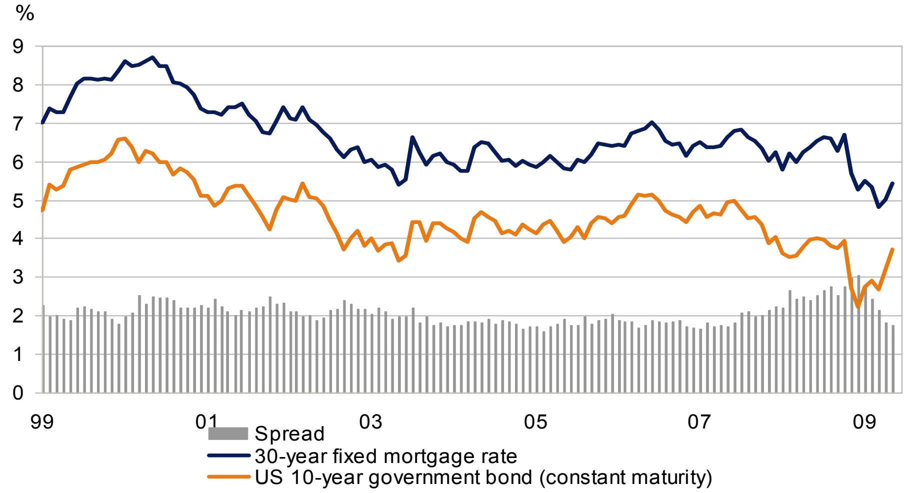
Meanwhile, although the fall in mortgage rates generally remains intact, the scope for further declines is limited by the back up in Treasury yields, which has reduced the spread between the two to its lowest for more than 10 years (charts 6 and 7).

Chart 6: The oil tax begins to rise again



Source: Thomson Datastream, Schroders, 24 June 2009

Chart 7: US Government bond yields and mortgage rates



Source: Thomson Datastream, Schroders, 24 June 2009

Deflation is a risk, but the emerging markets are relatively well placed

All this suggests that the necessary follow through from the inventory cycle to final sales is unlikely to occur with much vigour and hence our forecast of a very subdued recovery in 2010. Given the massive output gap, we still see scope for minor deflation in the US and our central view is for core CPI to fall to zero with prices actually declining in the second half of next year.

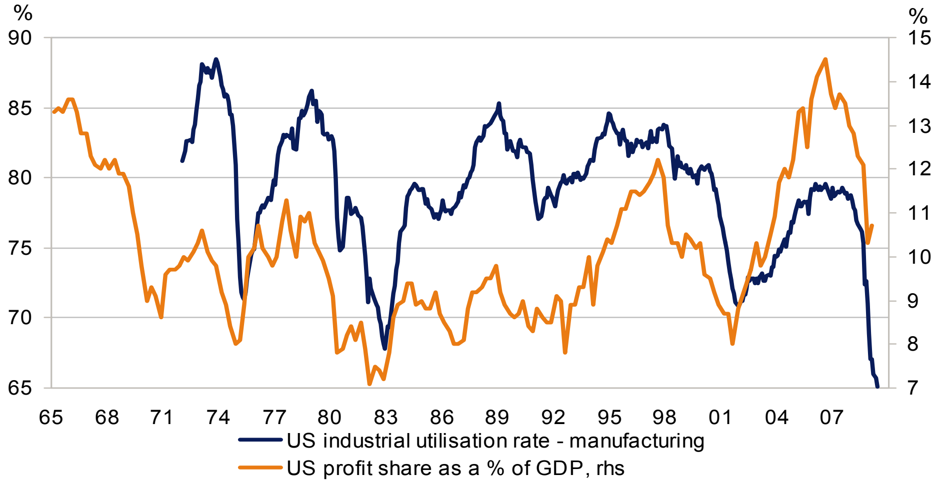
The emerging markets will not be immune from this downturn given their dependence on exports to the developed economies. Nonetheless, the absence of a major financial crisis and the strong financial position of many of these economies suggest that they are relatively well placed. Our forecasts indicate that they will account for an even greater share of global growth as a result.

Profits

Profits recession is not over yet

An environment of weak growth and modest deflation is not good for profit margins. The profit share is likely to be under further downward pressure as signalled by capacity utilisation (chart 8).

Chart 8: Profit share likely to decline further



Source: Thomson Datastream, Schroders, 24 June 2009

Consequently, our updated profits forecasts show a further decline in 2009 with top down economic profits down 25% after a 17% drop in 2008. Profits are expected to stabilise in 2010 to reflect a more positive performance from financials and better productivity by non-financial companies. The cost is a higher level of unemployment, which is forecast to rise to 10.5% of the workforce, about a percentage point higher than previously expected.

Table 1: Profits, earnings per share and PE ratios for S&P500

US	2008	2009	2010
Economic profits			
y/y%	-17.4	-24.9	-1.0
S&P 500 EPS			
Operating $	49.5	38.6	38.2
y/y%	-40.0	-21.9	-1.0
Reported $	15.1	25.6	28.9
y/y%	-77.2	69.6	12.8
S&P 500 PE market at:	**940**		
Based on operating EPS	19.0	24.3	24.6
Based on reported EPS	62.3	36.7	32.5
Source: Schroders			

Valuations

Falling corporate profits clearly push price-earnings ratios higher. As predicted, this has meant the trailing PE (price-earnings ratio) on the S&P500 (based on reported earnings) has moved to triple digit levels, well above the peak seen during the tech bubble. Going forward, this will move higher before it falls back to around 37 at the end of the year. The PE based on operating earnings (which exclude write-offs) is expected to average 24 this year and 25 next. We would note that on our quant model, equities are moving into expensive territory relative to bonds as a result of the rise in the historic PE ratio.

Can investors look through the downturn in corporate earnings?

Do these figures matter to investors? Judging from the performance of the equity market and risk assets, the answer must be no. Clearly, investors are looking through the current downturn knowing that other measures of valuation such as price to book, the trend or Shiller PE (which use longer run earnings measures) suggest that equities are cheap.

The key of course is whether we can be confident that earnings will return to their long run trend, an outcome which comes back to the macro view where as discussed above we are relatively cautious. Further out, we would also note that

- The increase in budget deficits means that taxes are likely to be higher in the future, thus reducing post tax earnings. Higher taxes may also impair the long run growth of the economy by reducing the incentive to invest.

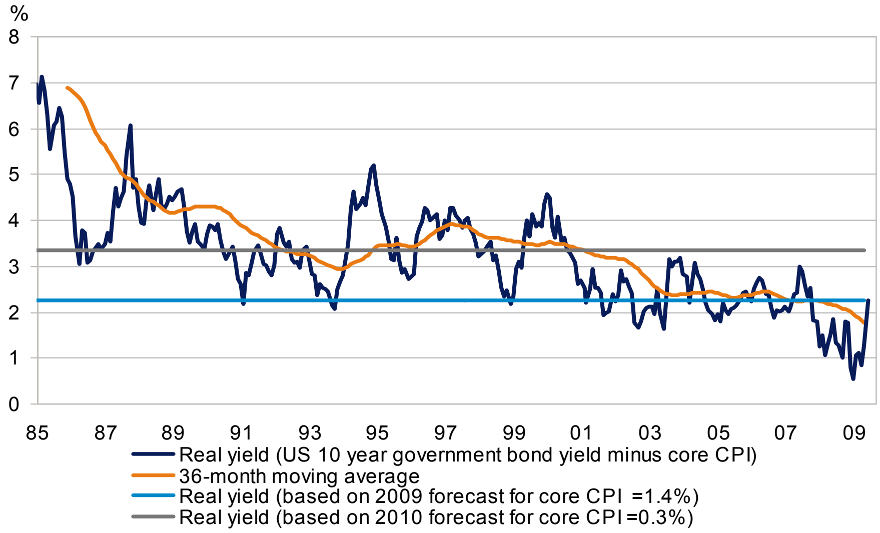
- Regulation of the financial sector is likely to be tighter with banks, for example being required to hold a higher proportion of government bonds as part of their capital base. Whilst this will improve the ability of the banking sector to access liquidity during a crisis, the cost of being more risk averse is also likely to be weaker growth.

- Going forward, central banks are already discussing the need for more tools to control bank behaviour through the cycle such as being able to alter reserve ratios. All these measures mean that leverage will play less of a role in driving EPS.

Do government bonds offer value?

Whilst there may be some debate about the value of equities, government bond yields are becoming attractive. In real terms, US government bond yields are now above their 3-year average based on the difference between the ten-year Treasury yield and core inflation. Using our forecasts of inflation for 2009 (1.4%) and 2010 (0.3%) real yields should start to look increasingly good value (see chart 9 on next page).

Chart 9: Value is returning to government bond markets



Source: Thomson Datastream, Schroders, 24 June 2009

In addition to this, we would also note that the slope of the yield curve between 2 and 10 years is at its steepest on record. The gap could widen further, but this suggests that the ten year could absorb a rise in the 2 year should the Fed signal a move toward tightening. Alternatively, a period of economic weakness would result in the gap closing as the 10-year rallies.

Chart 10: Record gap between 10 and 2 year bond yields

Source: Thomson Datastream, Schroders, 24 June 2009

Deficit fears

Coming back to the earlier comments about the US dollar, some attribute the combination of a weaker dollar and rising government bond yields to fears over the funding of the US budget deficit. This risk has been brought into focus by the decision to put the UK government on credit watch by Standard & Poor's. The UK's finances are very similar to those of the US in terms of debt to GDP and budget deficits. Meanwhile, China, the biggest creditor to the US, has expressed concern about the finances of the world's largest economy.

While such fears are justified and the consolidation of government finances will be a long running theme over the next few years, such an explanation is at odds with the recent performance of risk assets. If governments were going bust, it is unlikely that investors would be taking a more rosy view of the world economy and buying credit and equities.

Furthermore, we have always argued that funding problems are more likely to emerge when the economy is recovering and the private sector begins to compete again with the government in the capital markets. The resulting excess demand for capital would then push up the real rate of interest, crowding out private activity. The current weakness of capex and cutbacks in bank lending (forced saving) indicate we are some way from the point where the private sector begins to compete for funds again.

Conclusion

In the near term, risk assets are likely to continue to enjoy the summer supported by improving macro data, the liquidity created by low interest rates and QE and the pressure on institutional investors to reduce their overweight positions in cash. The USD could fall further and commodity prices continue to rise.

However, looking further out, after the bounce created by the inventory cycle, the recovery is likely to falter as final demand is found to be lacking. There could be talk of a double dip and deflation. Policy makers would find themselves on the back foot having already used most of their ammunition in cutting rates to zero and embarking on QE. Clearly, this would create a more difficult period for risk assets.

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Focus

Great (inflation) expectations

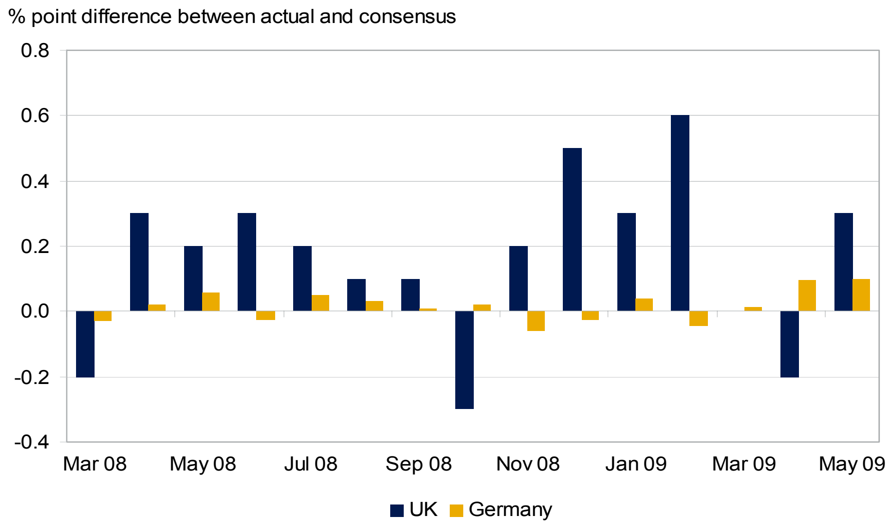
Green shoots and higher energy prices raise up inflation expectations…

It seems only yesterday that worries over deflation dominated sentiment across the world. Equity markets were being heavily discounted while government bonds were enjoying a tremendous rally. Meanwhile, annual headline inflation across the world is falling and has turned negative in the US, Japan, France, Spain and the UK (RPI), with many more countries about to follow. Indeed, the Eurozone annual CPI turned negative (-0.1%) for the first time in the union's history. Indices are however being driven down by large base effects caused by the record oil prices last year. As these base effects dissipate, will inflation return?

Markets seem to think so and perhaps for good reason. Since the start of the second quarter, the price of Brent crude oil has risen some 45% as the green shoots of recovery have begun to sprout. Global PMIs have been stronger than expected, and there are even signs that the US and UK labour markets may be in better shape than once feared.

All these factors, particularly the rise in oil and commodity prices are bound to feed through to higher headline inflation. In addition, inflation data, particularly in the UK has consistently surprised consensus estimates over the past year. Chart 11 shows the difference between Bloomberg consensus estimates of month on month CPI inflation and the actual ONS estimates. It also shows the same comparison for German harmonised CPI, which had not surprised by as much, though official estimates for April and May have been noticeably higher.

Chart 11: Annual inflation vs. Bloomberg expectations



Source: Bloomberg, ONS

Focusing too closely on the monthly gyrations of inflation indices is a hazardous occupation, though it is difficult to ignore the stubbornness of UK inflation over the past year. Is this phenomenon unique to the UK? The Governor of the Bank of England (Mervyn King) has previously pointed to greater pass-through of prices caused by the huge depreciation in Sterling over the past year. While we agree with the Governor, markets are pricing in higher inflation across the world and not just the UK. Chart 12 on the next page highlights the rise in 2-year breakeven rates over the past three

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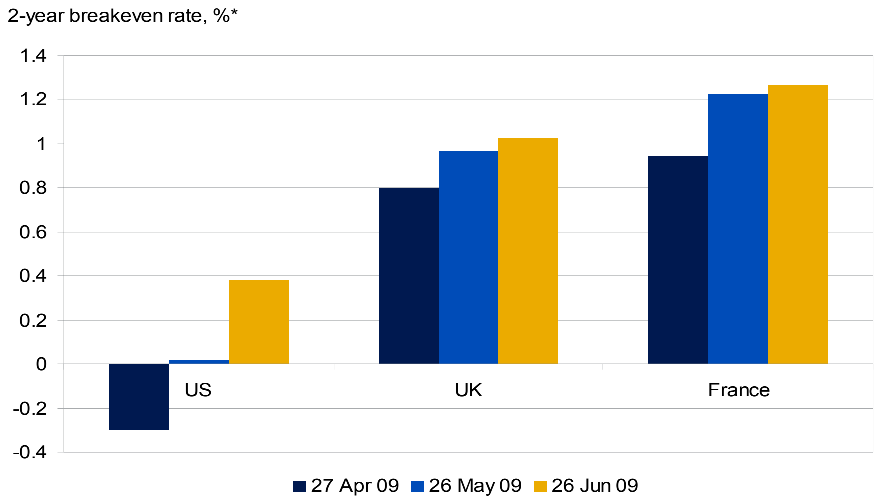
…as FOMC soften tone on deflation

months. The most noticeable rise has been in the market for the US, which rightly reflects the Federal Open Market Committee's (FOMC) softer tone on the likelihood of deflation at its June meeting.

Chart 12: Inflation expectations

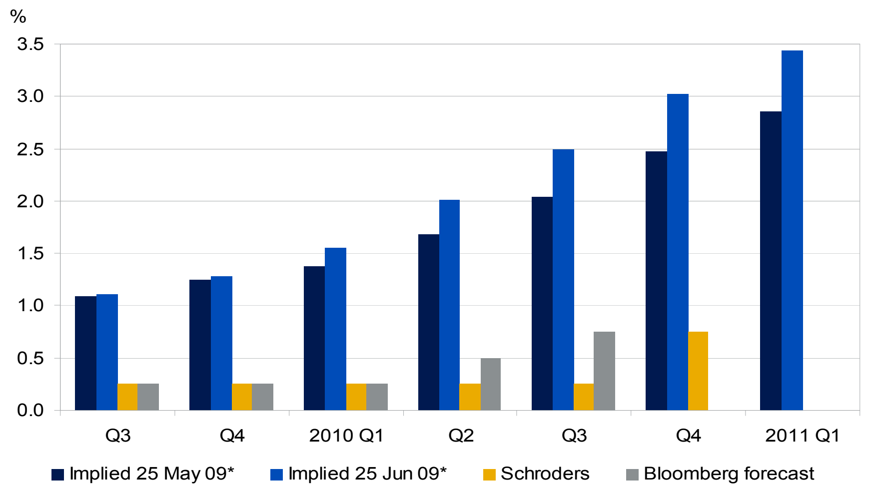


Source: Bloomberg.
* Breakeven rate measured as 2-year government bond yield minus 2-year inflation linked bond yield.

Market expects rate rises sooner rather than later…

With higher inflation expectations come expectations that central banks will raise rates earlier than previously expected. Chart 13 shows the change in market expectations for the Bank of England's official rate implied from future markets. Bearing in mind that there appears to be an immediate premium of around 50-75 basis points, the market expects the Monetary Policy Committee (MPC) to raise the base rate as soon as the fourth quarter of 2009. Given the ongoing need for deleveraging in the UK, we feel this will be too soon for a rate rise and do not expect any change to the base rate until the end of 2010. Our view is shared by many as highlighted by the Bloomberg consensus forecast (see chart 13).

Chart 13: BoE interest rate expectations



Source: Bloomberg, Schroders.
* Implied interest rates derived from future interest rates

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…but deflationary pressures will persist.

At this stage in the recovery, the rise in commodity prices and in particular energy could threaten the sustainability of the return to above trend growth. Higher oil and petrol prices act as a tax on consumers (chart 6 earlier), who will be suffering from weak wage growth and rising unemployment. Decade high unemployment rates coupled with very low capacity utilisation will inevitably exert significant deflationary pressure as a significant output gap takes time to close. This supports our view that central banks will keep rates low for some time as indicated by the FOMC in its latest meeting.

In returning to the question posed on whether inflation will return, the demand side fundamentals continue to point to weak inflation moving forward. However, should energy price inflation outweigh the deflationary pressures mentioned above, then the world is in for a very painful adjustment, and the return of stagflation.

Forecast Summary

I. Forecast summary - Schroders

Real GDP

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	1.1	-3.1	-2.8	0.8	1.9
UK	5.8	0.7	-4.5	-3.7	-0.5	0.7
Eurozone	25.5	0.7	-5.5	-4.2	-0.3	0.3
Japan	9.2	-0.7	-6.5	-6.6	1.0	1.3
Australia	1.9	2.5	-1.0	-0.2	1.5	1.5
OECD	71.4	0.7	-4.4	-3.8	0.4	1.1
China	7.1	9.0	7.0	7.5	7.5	8.4
Emerging*	28.6	6.3	0.8	0.4	3.5	4.3
World	100.0	2.3	-3.0	-2.6	1.3	2.1

Inflation CPI

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	3.8	0.0	-0.6	1.2	1.7
UK	5.8	3.6	1.6	1.7	1.5	1.8
Eurozone	25.5	3.3	0.7	0.4	0.5	1.2
Japan	9.2	1.7	-1.5	-1.2	-0.6	-0.6
Australia	1.9	4.5	1.8	1.6	1.5	2.2
OECD	71.4	3.3	0.2	-0.1	0.7	1.3
China	7.1	5.9	3.0	-0.3	4.0	1.6
Emerging*	28.6	7.9	2.8	4.2	3.3	4.5
World	100.0	4.7	1.0	1.1	1.5	2.2

* **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-08	Dec-09	Market	Dec-10	Market
US	28.9	1.00	0.25	0.94	0.75	2.39
UK	5.8	2.00	0.50	1.39	1.00	3.09
Eurozone	25.5	2.50	1.00	1.23	1.25	2.32
Japan	9.2	0.10	0.10	0.49	0.25	0.59
OECD	69.5	1.52	0.53	1.03	0.89	2.18

Market from forward futures strip as at 23/06/2009

Key variables

FX	Current	Dec-08	Dec-09	y/y%	Dec-10	y/y%
USD/ GBP	1.65	1.49	1.55	4.3	1.40	-9.7
USD/ EUR	1.40	1.35	1.40	3.5	1.30	-7.1
JPY/ USD	95.2	91.1	90.0	-1.2	100.0	11.1
GBP/ EUR	0.86	0.91	0.90	-0.8	0.93	2.8
Brent crude	66.2	40.5	59.1	45.9	65.7	11.2
US output gap %GDP	-6.3	-4.1	-8.2		-8.7	
Unemploy. %	8.1	6.9	9.7		10.5	

Source: Schroders, Datastream, IMF, Consensus Economics (June 09)

Baseline - deep recession in 2009, sluggish upturn in 2010

Our forecasts for global growth have been cut further since the last CMF with the world economy now expected to contract by 3% this year. The downgrade has largely been driven by the sharper than expected fall in first quarter GDP with the biggest forecast reductions being made in Europe and Japan.

Forecasts for the emerging markets have also been cut in response to weaker trade, although China has bucked the trend with a marginal upgrade following evidence that fiscal policy is boosting growth.

We continue to look for a modest recovery in global activity as the inventory cycle turns upward and monetary and fiscal policy gain traction. By past standards though the recovery is subdued as we expect the credit multipliers to be muted by ongoing de-leveraging in the household sector.

Inflation is forecast to fall sharply in 2009 helped by lower commodity prices and the slack created by the downturn. In 2010, inflation moves up again as a result of higher energy prices however deflationary pressures persist and the US is expected to experience a decline in core prices (deflation) in the second half of 2010.

Interest rates are now expected to rise slightly as the central banks bring an end to the ultra-loose period of monetary policy. By historical standards though, rates stay very low through out the forecast period.

Relative to consensus, the baseline is more deflationary with weaker growth and lower inflation.

Growth

- US growth forecast cut to -3.1% for 2009 as the credit crunch forces a de-leveraging of household and corporate balance sheets. Weakness is concentrated in the first half of the year with tax cuts and lower inflation lifting consumer spending in the second half. 2010 brings a modest sub par recovery as the credit crunch eases and monetary policy begins to take effect.
- Amongst the OECD, Japan is forecast to experience the greatest fall in GDP this year, a reflection of the hit to global trade. Sluggish recovery forecast for 2010. Forecasts for the UK and Eurozone cut further for 2009 to reflect the poor start to the year and weaker external environment.
- OECD activity now forecast at -2.8% in 2009 compared to a consensus of -2.3%.
- Emerging market growth is hit by weaker external demand and pressures on those economies with balance of payments deficits particularly in Central and Eastern Europe.
- Global growth to decline by 3% in 2009 (consensus -2.3%) from 2.3% in 2008 and recover to 1.3% in 2010, below the consensus estimate of 2%.

Inflation

- The combination of a significant output gap and lower energy prices push inflation forecasts for 2009 down to 0.2% for OECD and 2.8% for EM, taking global inflation to 1% (after nearly 5% in 2008). These forecasts are a tad higher than 3 months ago to reflect higher commodity prices.
- Inflation picks up in 2010 in line with higher commodity prices, however core rates drift lower as slower growth creates slack and squeezes pricing power. US core inflation negative in 2010.

(Note. We use forward futures rates for commodity price assumptions).

Monetary policy

- Central banks are expected to leave rates at current levels until the end of the year with the Bank of England and the Fed continuing with quantitative easing. Towards the end of next year, we look for rates to edge higher as central banks end the period of ultra-loose policy. Nonetheless, the forecast of weak growth and low inflation means policy is still considered to be loose by historic standards.

Currency

- This is a fairly neutral scenario for currencies. In the near term, evidence of recovery is likely to weaken the USD against the majors. Thereafter though the USD is expected to strengthen as the recovery disappoints and investors return to safe haven trades.
- The GBP underperforms as markets focus on the fiscal position and political risk in the run up to a general election.

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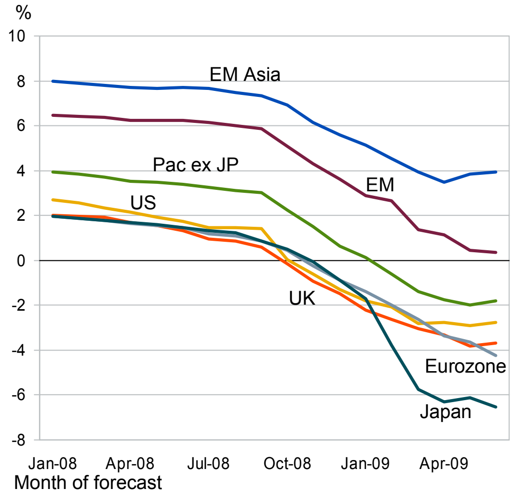
II. Updated forecast charts - Consensus Economics

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

2009 **2010**



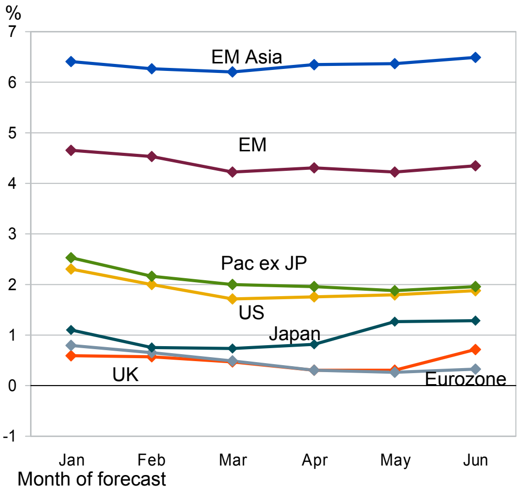
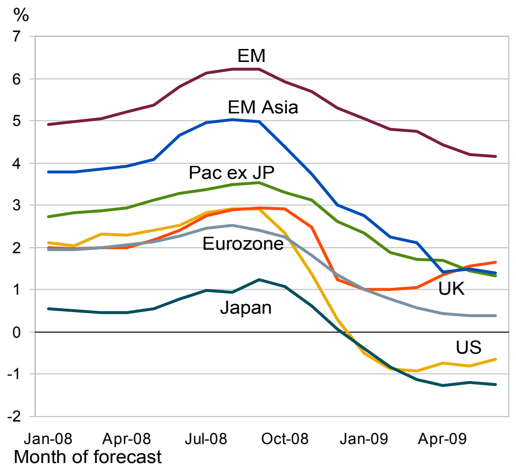
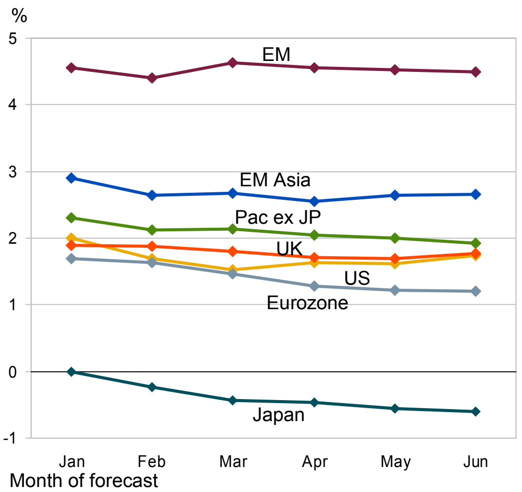


Chart B: Inflation consensus forecasts

2009 **2010**





Source: Consensus Economics (June 09), 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, Slovakia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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