

Schroders

Economic and Strategy Viewpoint

Keith Wade

Chief Economist
and Strategist

Azad Zangana

Senior European
Economist and
Strategist

Craig Botham

Emerging Markets
Economist

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

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

EM: Are exports emerging? (page 6)

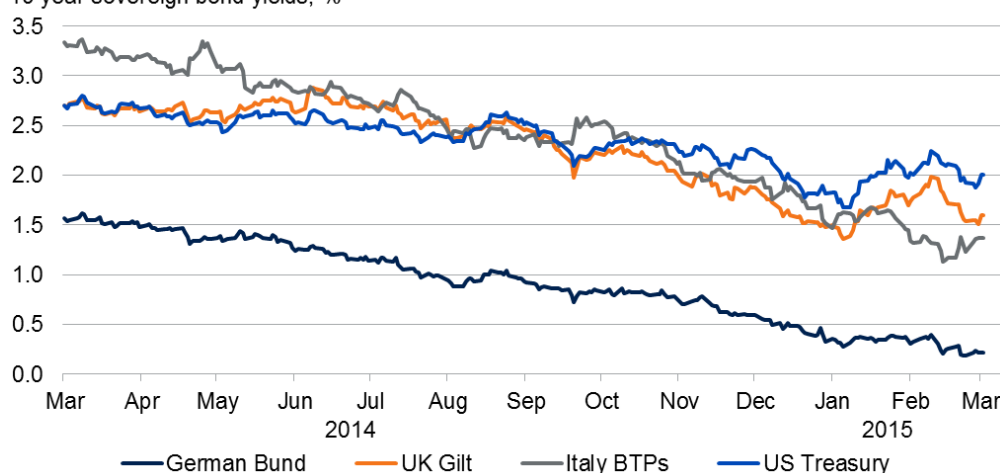
- A year of growth in the US and signs that the Eurozone may be turning the corner prompt a re-examination of export data in emerging markets. We could be in line for some isolated pockets of trade recovery this year.

Views at a glance (page 10)

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

Chart: Sovereign yields in retreat

10 year sovereign bond yields, %



Source: Thomson Datastream, Schroders. 26 March 2015.



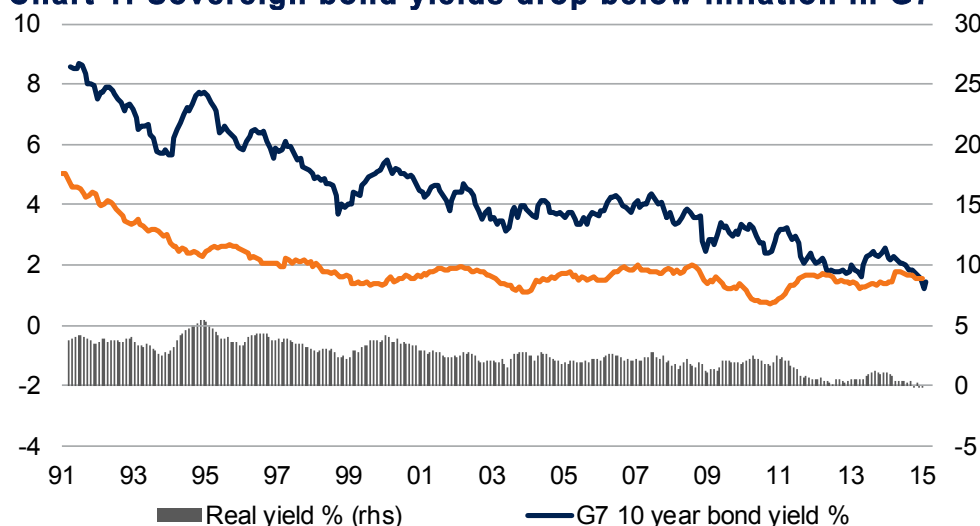
Schroders

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

Interest rates fall to new lows

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

Chart 1: Sovereign bond yields drop below inflation in G7



Source: Thomson Datastream, Schroders, 26 March 2015.

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

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

However, there is a concern that the latest fall in interest rates is just another chapter in a long running saga of declining yields and that the underlying trend is being driven by secular stagnation. This occurs when an economy suffers from a chronic deficiency of demand such that it requires lower and lower interest rates to stimulate activity. It is an idea that has been around for many years, but was recently resurrected by Larry Summers, the former US Treasury Secretary¹.

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

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

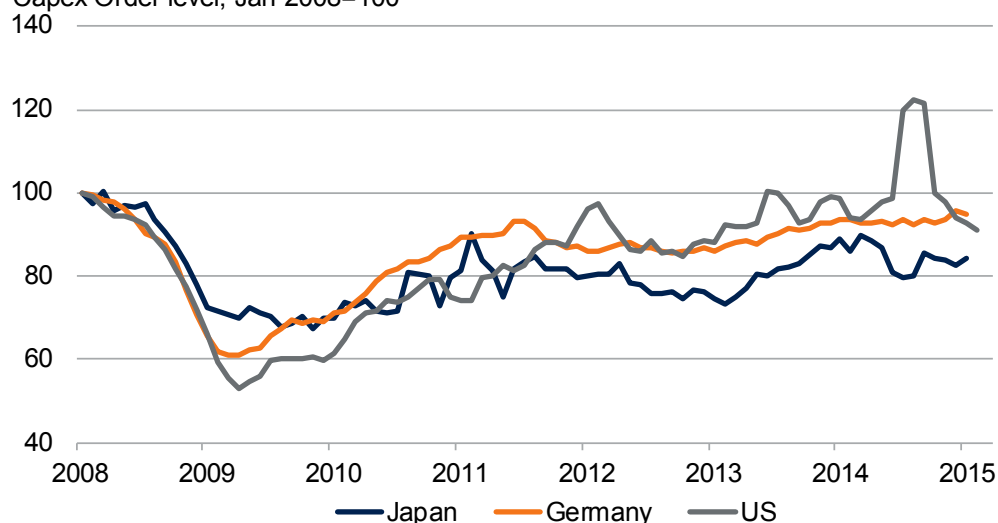
Lack of investment ties in with the secular stagnation view

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

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

Chart 2: Business investment still struggling

Capex Order level, Jan 2008=100



Source: Thomson Datastream, Schroders, 26 March 2015.

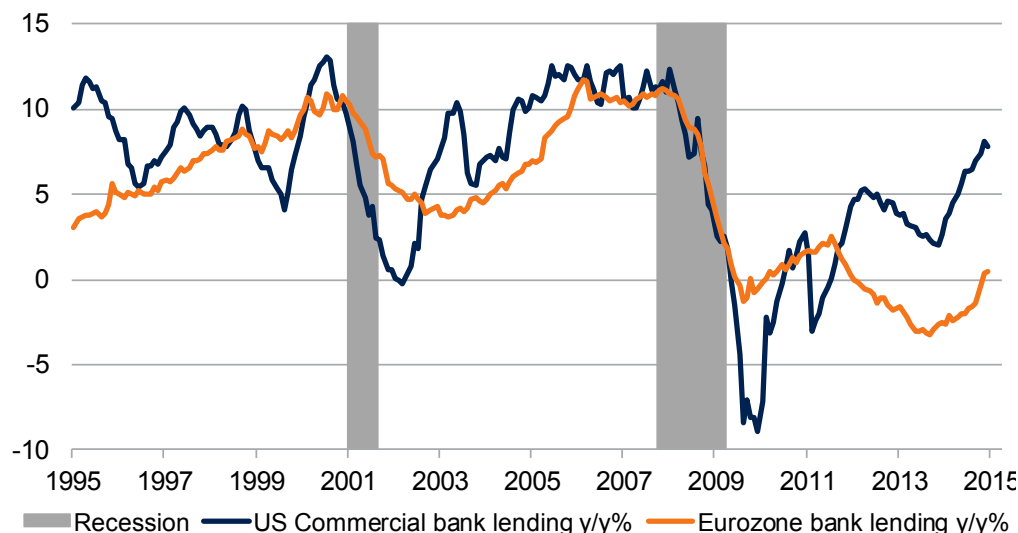
Whilst there is evidence for secular stagnation we would still see it as being too pessimistic. It was always the case that the shock to the banking system would take time to be overcome as the private sector went through a period of balance sheet repair. QE has helped speed that process by keeping interest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

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

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

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

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



Source: Thomson Datastream, Schroders, 26 March 2015.

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

Is China next for balance sheet repair?

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

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

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

Overall, this suggests that the weakness of growth in the world economy is still a consequence of the crisis, as Reinhart and Rogoff made clear in their study², recoveries from financial crises take considerably longer than those in a normal cycle. Consequently, we continue to forecast recovery in the developed world this year with the US picking up in the second quarter and growth in Europe and Japan improving. Admittedly though, at present it is difficult to distinguish this from a world suffering from secular stagnation, a factor that will weigh on long rates.

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

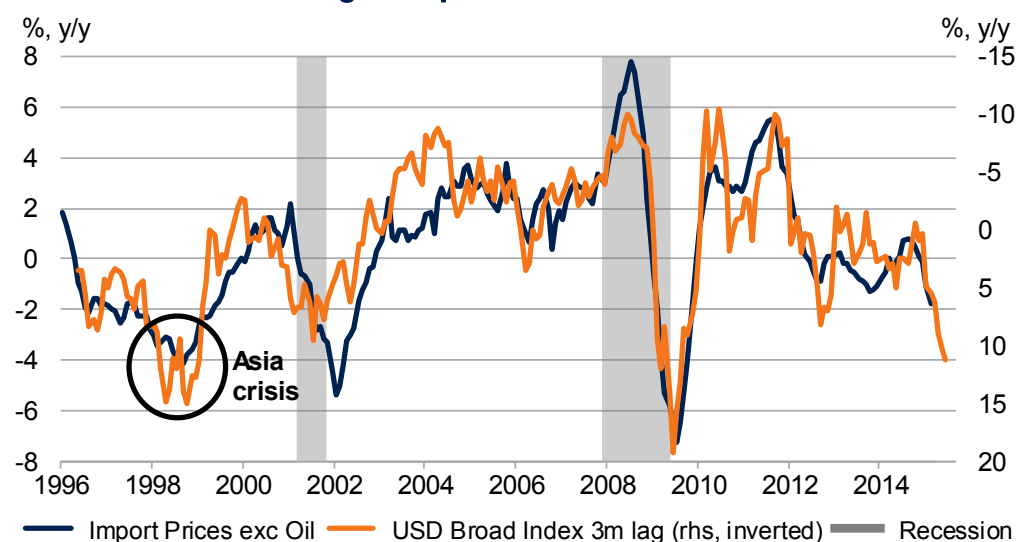
Forecast update: pushing out Fed rate rise

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

The factor which has swung the view has been the strength of the US dollar, which has exceeded even our bullish expectations. This may be one reason for the weakness of durable goods orders in the US as the currency hits profitability. More importantly from the Fed's perspective is that dollar strength is beginning to depress core inflation through lower import prices (chart 4). Although the Fed appears to be looking through the energy driven decline in headline CPI, it will take account of a lower core rate which is running at 1.7%, a tad below the 2% which it would prefer. Effectively the dollar has tightened financial conditions for the Fed (for more details see our recent Quickview: *Dollar strength tips Fed towards later rate rise*, 19 March 2015³).

Dollar strength
is doing the
Fed's job

Chart 4: Dollar strength depresses inflation



Source: Thomson Datastream, Schroders, 26 March 2015.

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

US growth
should benefit
EM exports...

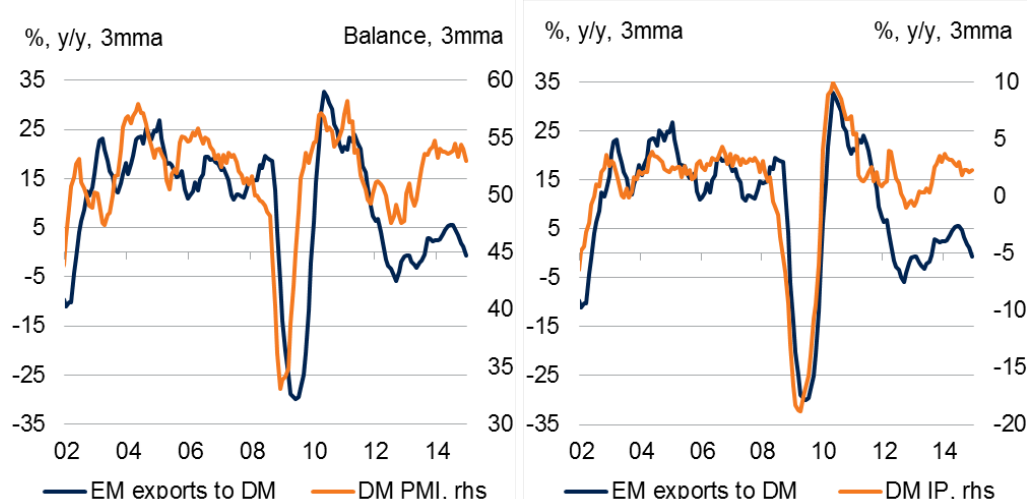
EM: Are exports emerging?

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

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

...but the
benefits seem
greatly reduced

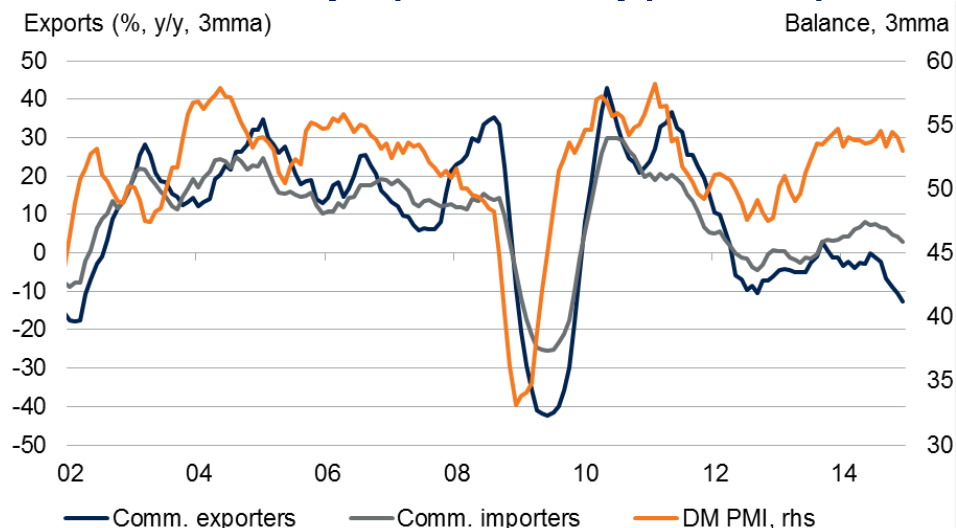
Chart 9: EM exports benefitting less from DM growth



DM PMI and IP are GDP weighted averages of those figures for the US, EU and Japan.

Source: Thomson Datastream, IMF, Schroders. 25 March 2015.

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

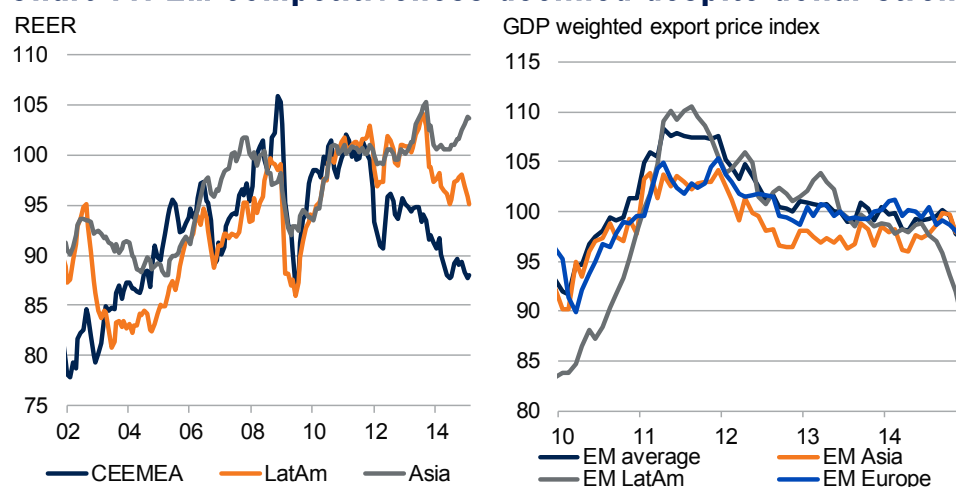
Chart 10: Commodity exporters hurt by price collapse

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

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

Nominal depreciation has not seen effective depreciation

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

Chart 11: EM competitiveness declined despite dollar strength

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

EM export prices are falling, transmitting deflation

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

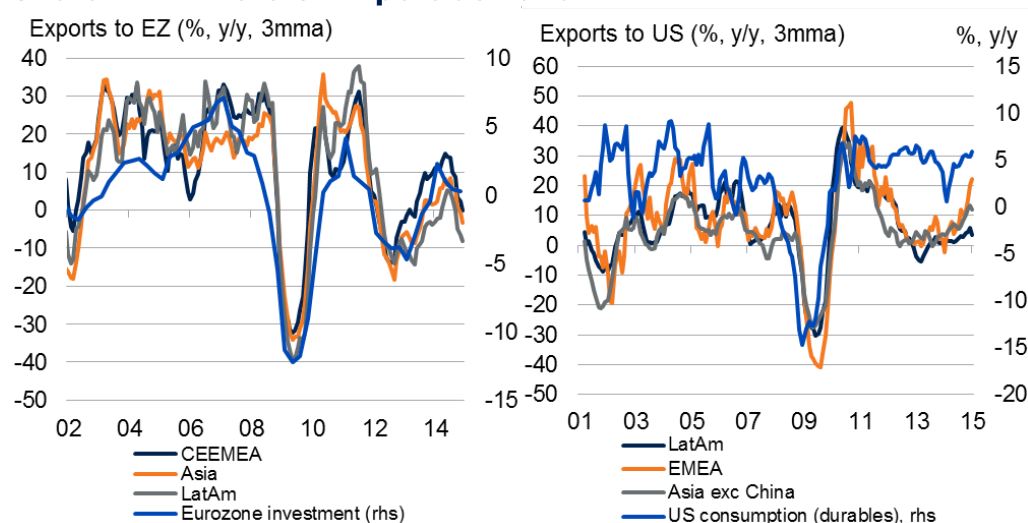
Waiting for a catalyst

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

Exports to the US have actually been recovering...

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

Chart 12: Drivers of import demand in DM



Source: Thomson Datastream, Schroders. 26 March 2015.

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

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

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

**Still hard to be
positive on
LatAm**

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

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

Schroder Economics Group: Views at a glance

Macro summary – March 2015

Key points

Baseline

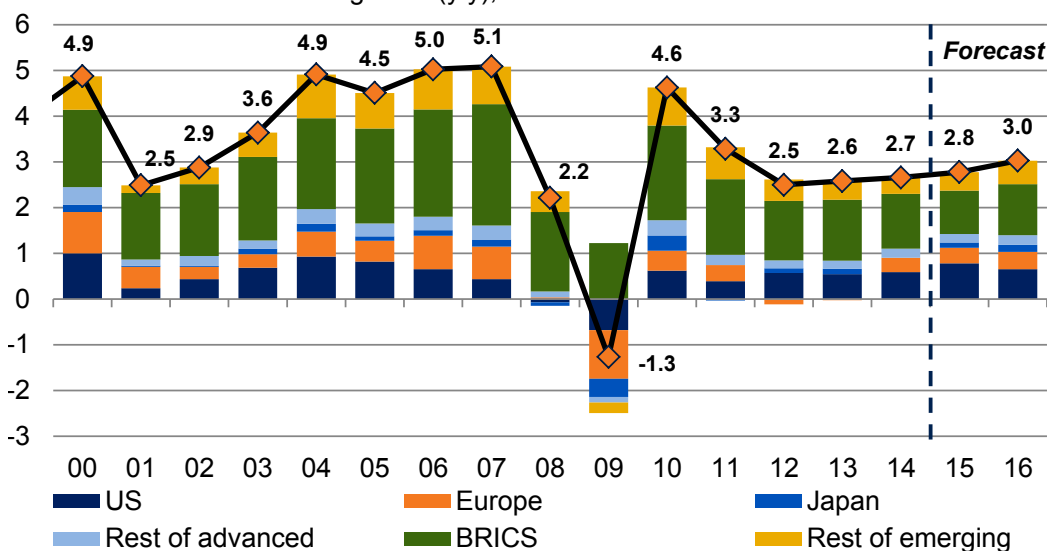
- Global recovery to continue at modest pace as the upswing in the advanced economies is offset by slower growth in the emerging markets. Lower energy prices will push inflation in the advanced economies to its lowest level since 2009.
- US economy on a self sustaining path with unemployment set to fall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

Risks

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

Chart: World GDP forecast

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



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

Schroders Baseline Forecast

Real GDP

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

Inflation CPI

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

Interest rates

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

Other monetary policy

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

Key variables

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

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

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

Market data as at 27/03/2015

Previous forecast refers to November 2014

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

Updated forecast charts – Consensus Economics

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

Chart A: GDP consensus forecasts

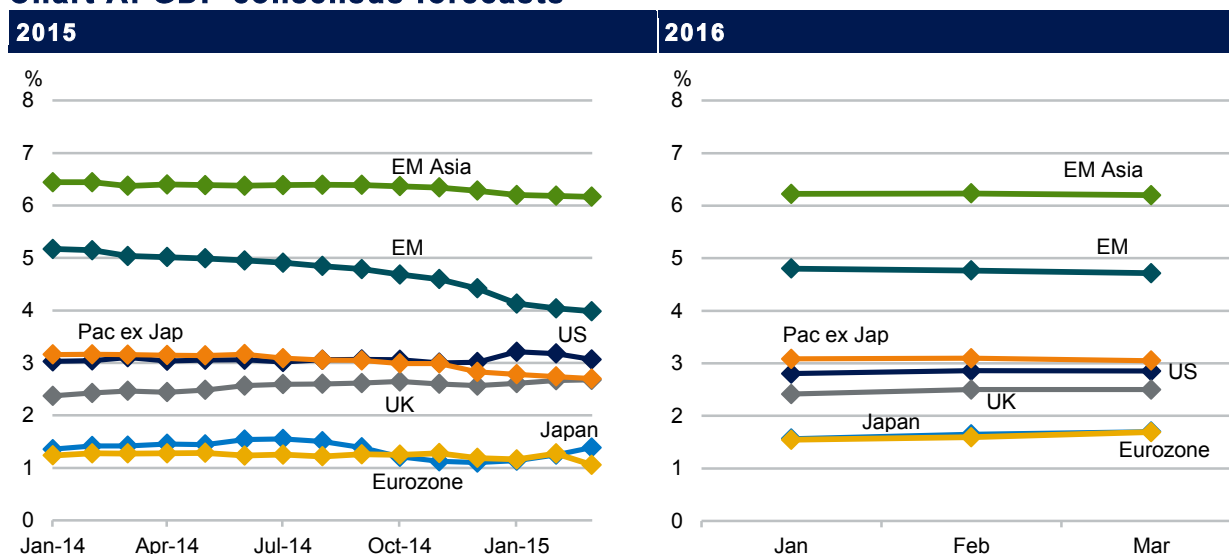
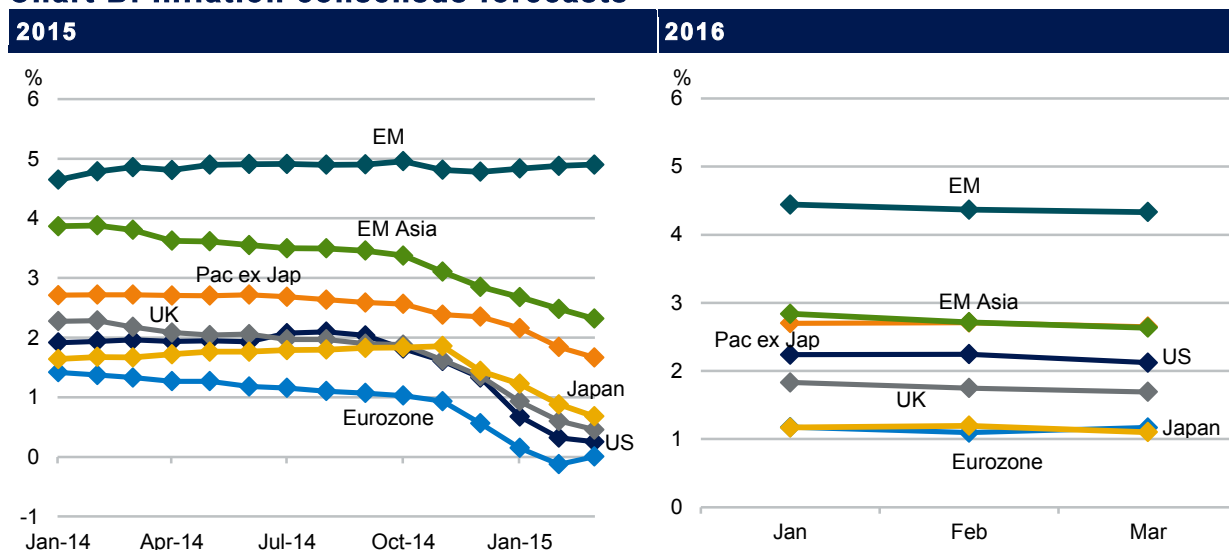


Chart B: Inflation consensus forecasts



Source: Consensus Economics (March 2015), Schroders.

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.

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

The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. We accept no responsibility for any errors of fact or opinion and assume no obligation to provide you with any changes to our assumptions or forecasts. Forecasts and assumptions may be affected by external economic or other factors. The views and opinions contained herein are those of Schroder Investments Management's Economics team, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds. This document does not constitute an offer to sell or any solicitation of any offer to buy securities or any other instrument described in this document. The information and opinions contained in this document have been obtained from sources we consider to be reliable. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that Schroders has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. For your security, communications may be taped or monitored.